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Recommended Citation

Frank S. Alexander, *Mortgage Prepayment The Trial of Common Sense*, 72 Cornell L. Rev. 288 (1987)
Available at: <http://scholarship.law.cornell.edu/clr/vol72/iss2/2>

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MORTGAGE PREPAYMENT: THE TRIAL OF COMMON SENSE

Frank S. Alexander†

[T]he triumph of common sense over professional prejudices has never been more strikingly illustrated, than in the gradual manner, in which Courts of Equity have been enabled to withdraw mortgages from the stern and unrelenting character of conditions at the Common Law.

Joseph Story¹

For those of us with ample debts, the possibility of paying off a home mortgage ahead of schedule may seem remote. If we decide to sell the property or refinance the mortgage and thereby retire some or all of our indebtedness, we might think that the lender will be as happy to receive our money as we are to pay it. Such is not necessarily the case, however. The lender might well refuse an offer to pay the outstanding principal with accrued interest and insist that final payment await the appointed day. Indeed, courts have allowed lenders to reject a debtor's offer to prepay the principal, the accrued interest to date, *and* interest which would accrue over the original remaining term of indebtedness.

Even though borrowers do not normally anticipate paying off a home mortgage prior to the dates set forth in the monthly amortization schedules, a borrower's ability to retire mortgage indebtedness ahead of time is likely to become a major issue in the coming years. In a period of relatively stable interest rates most lenders will allow borrowers to pay off their home mortgages early. When interest rates on long-term, fixed-rate mortgages fluctuate dramatically, however, both lenders and borrowers become concerned with the possibility of early debt retirement. Borrowers do not want to be locked into high interest rates when rates are declining. Similarly, lenders want to maximize the yield on their investments. The majority of residents in this country will want to pay off a mortgage

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¹ 2 J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 281-82 (2d ed. 1839).

prematurely in the coming decades. The economic significance of the right to prepay is highlighted by the fact that over sixty-three percent of American families own rather than rent their living units,² with total residential mortgage indebtedness exceeding \$1.8 trillion in 1985.³

Since the early nineteenth century the law has been clear: absent express contractual language to the contrary, a borrower has no unilateral right to retire mortgage indebtedness prior to the date specified in the underlying promissory note.⁴ A lender may insist on a surcharge, or premium, as consideration for accepting the borrower's early payment of the debt. Such prepayment charges in residential mortgages have been incorporated as standard clauses for over fifty years.⁵

Litigation and legislation in residential finance over the past ten years have focused on the enforceability of "due-on-sale" clauses.⁶ Such clauses usually permit lenders the option to demand payment of the entire indebtedness upon sale or transfer of the mortgaged property. In the near future the focus will shift to the prepayment clause and the borrower's right to retire the debt prior to maturity. Two recent factors, the emergence of the private secondary mortgage market and mortgage-backed securities⁷ and federal preemption of state residential finance law,⁸ will create pressure for the development of prepayment charges as increasingly significant elements in residential mortgage transactions.

For the past one hundred and fifty years legal scholarship has assumed that a borrower's inability to prepay mortgage indebtedness without the lender's consent was a principle embedded in the common law since its early beginnings. A reexamination of the leading cases and commentaries, however, reveals that this assumption is unjustified. To the contrary, this principle first emerged as a rule of law in the nineteenth century, when major shifts in the economic aspects of residential finance provided the impetus for transformation of the common law of prepayment.⁹ Similarly, major economic shifts in the latter part of this century will lead to further transformation in the law. From both viewpoints, the power of economic considerations to shape American law is evident.

² BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE U.S.: 1986, table 1308 (106th ed. 1985).

³ *Id.* at table 843.

⁴ See *infra* notes 13-18 & 155-59 and accompanying text.

⁵ See *infra* notes 188-93 and accompanying text.

⁶ See *infra* notes 223-37 and accompanying text.

⁷ See *infra* notes 199-221 and accompanying text.

⁸ See *infra* notes 223-38 and accompanying text.

⁹ See *infra* notes 188-98 and accompanying text.

Like the history of mortgage law in general, the history of the law of mortgage prepayment exemplifies the inherent tension between the need for stable and predictable rules and the desire for flexibility in particular circumstances. In perhaps no other body of law has the role of equity jurisprudence been so significant in tempering strict rules of law. Both the strict rules of law and equitable adjustments of such rules have been defended in terms of "common sense." Each side in the prepayment dispute—debtors seeking to prepay mortgages and creditors seeking to stabilize investments—has characterized the arguments supporting their respective positions as self-evident conclusions drawn from allegedly clear premises. In reality, the premises are far from clear. Moreover, the legal and equitable considerations have shifted with changes in perceptions of the nature and function of a mortgage from a security device whose primary function was to assure repayment of a debt to a commercial investment designed to maximize yield.

These changes in mortgage law over the centuries occurred in part through a shift in the understanding of mortgages from a function of property law to a function of contract law. From the fourteenth through the eighteenth centuries mortgages were viewed primarily as incidents of real property ownership and were governed by the legal and equitable rules of property. During the nineteenth century mortgages were viewed increasingly as financial investments and were governed by principles of contract law.¹⁰ An appreciation of this evolutionary story, this trial of common sense, may enable us to see more clearly what new rules for mortgage prepayment may be appropriate in the future.

Part I of this Article investigates the history of mortgage prepayment and traces the transformation of the law in the early nineteenth century. Part II summarizes the law of prepayment charges in the United States during the last 150 years. Part III evaluates contemporary pressures that impact on residential mortgage prepayment and proposes contours for rules of prepayment in coming years.

I

THE HISTORY OF MORTGAGE PREPAYMENT

Since the early nineteenth century the general rule has been that a debtor cannot, without the lender's consent, prepay a mortgage debt. More precisely, when a specific amount of indebtedness is secured by a mortgage¹¹ covering the debtor's real property, and

¹⁰ See *infra* notes 89-102 and accompanying text.

¹¹ The term "mortgage" is used throughout this article to refer to the transfer of an interest in real property as security for a debt. In this generic sense the term includes

the note specifies a date certain for repayment of the debt, the debtor is not entitled to pay the indebtedness before that date unless the lender agrees to accept such payment.¹² This is the requirement of perfect tender in time.

Two of the earliest and most frequently cited precedents for this rule are *Abbe v. Goodwin* (1829)¹³ and *Brown v. Cole* (1845).¹⁴ In *Abbe* the plaintiff purchased property from the defendant and executed a purchase money mortgage securing four interest-bearing promissory notes, payable one per year for four years. Two years later the plaintiff, having paid in full two of the notes, tendered to the defendant the amounts due on the remaining two notes.¹⁵ The defendant refused to accept the tender and the plaintiff brought an action to redeem the mortgaged premises. The Supreme Court of Errors of Connecticut dismissed the plaintiff's complaint with the following words:

What is the object of this bill? It is to compel the defendant to accept his money before it is due, and relinquish his security. In other words, it is to substitute another contract for that which the parties have entered into. It will be in vain to search for authorities to that effect. None are shewn. It is opposed to the whole doctrine of contracts It is surely too bald to insist that the obligor, by his own act, may discharge the contract before it is due. We might next expect to be pressed, on some real or imaginary equity, to enforce the payment of money before it is due, or to permit an obligor to be discharged upon payment of fifty *per cent.* of the sum due.¹⁶

In *Brown* the plaintiff-debtor mortgaged a leasehold interest as security for a loan in the amount of £1000, to be repaid in one year, with five percent interest payable quarterly. Eight months later the plaintiff-debtor had a chance to sell his property interest and tendered the full amount due on the note. The defendant-lender refused payment, and the plaintiff filed a bill before the English Chancery Court seeking an order compelling redemption and reas-

formal mortgages utilized in lien theory states, deeds to secure debt utilized in title theory states, and deeds of trust. For historical background on the distinction between the civil law and common-law approaches as it affects mortgage prepayments in title theory and lien theory states, see *infra* notes 82-84 and accompanying text.

¹² For variations on the obligation to make payment on a date certain, such as "on or before a date certain" or "no later than a date certain," see *infra* notes 155-59 and accompanying text.

¹³ 7 Conn. 377 (1829).

¹⁴ 14 L.J.-Ch. 167 (1845).

¹⁵ *Abbe*, 7 Conn. at 377. The plaintiff tendered not only the principal balance of \$225 due on each note together with accrued interest, but also the interest which would have accrued on the notes at the date specified for final payment. *Id.* at 377.

¹⁶ *Id.* at 383. The facts suggest that the court may have perceived something other than the right to prepay the debt as the controlling issue in this case. See *infra* note 111.

signment of the property to the plaintiff.¹⁷ The Vice Chancellor summarily dismissed the complaint, reasoning that "[i]f mortgagors were allowed to pay off their mortgage money at any time after the execution of the mortgage, it might be attended with extreme inconvenience to mortgagees, who generally advance their money as an investment."¹⁸

Subsequent cases¹⁹ and numerous nineteenth- and twentieth-century treatises on mortgage law²⁰ cite these two cases as authority for the rule of perfect tender in time. By the turn of the twentieth century each American jurisdiction had accepted this rule. A 1909 South Carolina Supreme Court opinion typifies judicial acceptance of the rule: "In all the cases . . . where the question has been decided under the common law, it has been held that the creditor cannot be compelled to give up his investment before maturity."²¹

A careful review of prenineteenth-century cases and treatises, however, reveals that this rule of law was not as settled as courts and commentators have suggested. The history of mortgage law from the fourteenth through the eighteenth centuries actually suggests that a debtor *could* redeem property from the mortgage upon payment of the full indebtedness at any time prior to the final due date. The few cases that early nineteenth-century courts relied upon to justify a contrary rule constitute weak authority at best. Nonetheless, subsequent cases and treatise writers uncritically accepted the holdings in *Abbe* and *Brown* and the concept of perfect tender in time became the rule of law.

¹⁷ *Brown*, 14 L.J.-Ch. at 167.

¹⁸ *Id.* at 168. As in *Abbe*, the plaintiff-debtor in *Brown* tendered not only outstanding principal and accrued interest, but also interest which would have accrued at the date set for final payment. The court accepted the rationale suggested by the defendant that "[i]t would be extremely inconvenient to the defendant to receive back his money previous to the [original due date]. If such a principle was permitted, it might be the cause of much loss to the defendant, by the funds falling during the time." *Id.* at 167.

¹⁹ See, e.g., *Westminster Inv. Corp. v. Equitable Assurance Soc'y*, 443 F.2d 653, 657 n.5 (D.C. Cir. 1970); *Dugan v. Grzybowski*, 165 Conn. 173, 176, 332 A.2d 97, 99 (1973); *Bernard v. Toplitz*, 160 Mass. 162, 163, 35 N.E. 673, 674 (1893); *Dorsey v. Conrad*, 49 Neb. 443, 456, 68 N.W. 645, 648 (1896); *Weir v. Granite State Provident Ass'n*, 56 N.J. Eq. 234, 238, 38 A. 643, 644 (1897); *Pyross v. Fraser*, 82 S.C. 498, 499, 64 S.E. 407, 407 (1909). For a discussion of other nineteenth-century cases, see *infra* notes 110-13 and accompanying text.

²⁰ See, e.g., 1 F. HILLIARD, *THE LAW OF MORTGAGES OF REAL AND PERSONAL PROPERTY* 475 n.(b) (4th ed. 1872) (1st ed. n.p. 1853); 2 L. JONES, *A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY* § 1137 n.18 (8th ed. 1928); G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* 422 (2d ed. 1985).

²¹ *Pyross v. Fraser*, 82 S.C. 498, 499, 64 S.E. 407, 407 (1909) (citing *Abbe* and *Brown*). In *Pyross* the debtor tendered the final installment of \$47 on the mortgage debt approximately four months early. The creditor refused the tender and, following non-payment of the final installment on the specified due date, brought a foreclosure action. Holding that "tender before maturity was not a legal tender," the court affirmed the decree of foreclosure. *Id.*

An understanding of the transformation of the law of mortgage prepayment in the early nineteenth century is useful for several reasons. First, it reveals the jurisprudential fallacy of blindly citing case precedent for a proposition, and thereby assuming that the proposition has always been true. Second, it demonstrates the manner in which judicial opinions, in attempting to justify a legal rule, often fail to acknowledge underlying economic motivations. Instead of acknowledging economic considerations, courts have based the rule prohibiting prepayment of a debt on the concept of a reciprocal relationship between the debtor and creditor. The concept of reciprocity, however, had to be twisted from earlier formulations to fit the new conclusion. Third, despite the absence of express economic analysis in the cases, the transformation of mortgage prepayment law illustrates the law's susceptibility to commercial and economic forces. Finally, an appreciation of this nineteenth-century transformation provides guidance for the evaluation of pending changes in mortgage prepayment law.

A. Mortgage Prepayment Before the Nineteenth Century

The first extensive discussion of the English law of the gage (the forerunner of the contemporary mortgage) is found in Glanvill's twelfth-century treatise.²² Glanvill identified three variables in the gage: (1) whether the gage has a fixed term; (2) whether the creditor takes possession of the property during the term; and (3) whether rents and profits from the property are to be applied in reduction of the debt.²³ When there is a fixed term for payment of the debt, the creditor cannot demand payment prior to the expiration of that term; if no term is specified, however, the debt is due on demand. Glanvill averred, "When the debtor has repaid the debt, the creditor must restore to him in its original condition the thing gaged"²⁴ Although this proposition falls short of an affirmation of a debtor's right to prepay at will, Glanvill never suggested

²² THE TREATISE ON THE LAWS AND CUSTOMS OF THE REALM OF ENGLAND COMMONLY CALLED GLANVILL 120-126 (G. Hall ed. and trans. 1965) [hereinafter GLANVILL]. For summaries of the historical evolution of the early gage, see 2 F. POLLOCK & F. MAITLAND, THE HISTORY OF ENGLISH LAW 117-124 (1898 & photo. reprint 1968) and T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 603-609 (5th ed. 1956). The transfer of an interest in property as security for a debt is not a phenomenon unique to western law. References to real and personal property as a pledge and the obligation of the secured party to return the pledge are found in the Deuteronomic Code, *Deuteronomy* 24:17, and in *Ezekiel* 18:16.

²³ GLANVILL, *supra* note 22, at 120-21.

²⁴ *Id.* at 123. Glanvill separately stated, "It should, however, be noted that if anyone has paid, or in due form offered to pay, what he owes, and the creditor still maliciously detains the gage, the debtor shall have the following writ upon complaint" *Id.* at 124. Although this clause appears without any indication of whether Glanvill was referring to payment prior to or at the end of the term, the writ set forth immediately

that prepayment without the creditor's consent was prohibited.²⁵ The second variable was significant in the late medieval period because the majority of gages required possession by the creditor during the period of indebtedness.²⁶ The third variable proved to be the most problematic. Glanvill praised the living gage, the *vivum vadium*, in which the rents and profits received by the creditor from the land during the period of possession were applied against the indebtedness. He condemned as "unjust and dishonorable" the creditor's failure to apply these proceeds to the principal indebtedness, characterizing this as a dead gage—the *mortuum vadium*, or the "mort gage."²⁷

Another variation on the early mortgage—the "Welsh mortgage"—permitted the creditor to take possession of the mortgaged property and receive the rents and profits as a form of interest rather than as payment of the principal. The Welsh mortgage differed from contemporary mortgages and from the earlier gage in that it typically lacked a covenant by the debtor to repay the indebtedness²⁸ and did not specify a term for repayment of the debt.²⁹ In the absence of such provisions, the creditor could not foreclose and

following the clause contains the phrase "until the end of a term which is now past." *Id.* at 125.

²⁵ At least one commentator has construed Glanvill's statement to mean that "[a]s soon as the debt be discharged or payment properly tendered, the gagee is under the duty of giving up possession to the gagor." Hazeltine, *The Gage of Land in Medieval England*, 17 HARV. L. REV. 549, 555 (1904) (emphasis added).

²⁶ The distinction between immediate possession in the creditor and possession remaining in the debtor until default is found in corresponding Roman, German, and French law. See Hazeltine, *supra* note 25, at 550-551. For an extensive comparative law analysis of early mortgage forms, see Wigmore, *The Pledge-Idea: A Study in Comparative Legal Ideas*, 10 HARV. L. REV. 321 (1897).

²⁷ GLANVILL, *supra* note 22, at 124. Though this form of gage was considered usurious and condemned as a sin, it was not prohibited as a matter of law and was apparently widely used. Writing three hundred years later, Littleton adopted a different explanation for the origin of the French *mort gage*. He suggested that a mortgage contains the obligation of the debtor to pay at the date certain (the performance of which terminates the obligation) or to lose the property upon nonpayment (in which case the debtor's ownership interest terminates). LITTLETON'S TENURES § 332 (E. Wambaugh ed. 1903) [hereinafter LITTLETON]. Blackstone, Coke, and Kent essentially followed this explanation. See 3 W. BLACKSTONE, COMMENTARIES ON THE LAW OF ENGLAND *157; 2 E. COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND; OR A COMMENTARY UPON LITTLETON 205a (C. Butler 19th ed. 1853); 4 J. KENT, COMMENTARIES ON AMERICAN LAW *137. A recent commentator has suggested a different derivation. See L. FRIEDMAN, A HISTORY OF AMERICAN LAW 216 (1973) ("A mortgage is 'dead' to the creditors, since the borrower stays in possession of the land and keeps whatever it produces, over and above the debt.").

²⁸ See, e.g., *Turner v. Crane*, 23 Eng. Rep. 394 (Ch. 1683); *Lawley v. Hooper*, 26 Eng. Rep. 962 (Ch. 1745).

²⁹ See, e.g., *Orde v. Heming*, 23 Eng. Rep. 559 (1686); *Yates v. Hambly*, 26 Eng. Rep. 618 (Ch. 1742).

receive title to the property,³⁰ and the debtor had an indefinite period of time in which to redeem his property.³¹

By the time of Littleton's *Tenures* (c. 1480), use of the Welsh mortgage was declining for two reasons. First, creditors did not know when, if ever, the debtor might repay the debt, reclaim the property, and insist upon an accounting for the proceeds of the land during the term of the debt. Second, the uncertainty of redemption created significant obstacles to the subsequent alienability of the subject property: the creditor could not foreclose and thus was unable to obtain clear title to the property to convey to subsequent purchasers.³²

These difficulties led to the gradual replacement of the Welsh mortgage by a security instrument in the form of a conditional fee. As security for the indebtedness, the debtor conveyed to the creditor a fee simple estate upon the condition that if the debtor paid principal and interest at a date certain, the creditor would reconvey the estate to the debtor.³³ This new device permitted the creditor to anticipate a date certain upon which either repayment would be made or the conditional limitation would disappear, leaving an estate in fee simple. It also brought strict legal enforcement of the

³⁰ See, e.g., *Curtis v. Holcombe*, 6 L.J.C.P. 156 (1837).

³¹ In *Yates v. Hambly*, 26 Eng. Rep. 618 (Ch. 1742), for example, 40 years had passed since the execution of the mortgage and the creditor had constructed improvements on the property. Even so, the debtor was allowed to redeem the property. *Id.* at 620. Lord Hardwicke rejected the creditor's statute of limitations defense on the grounds that there was no forfeiture to give rise to a cause of action. Moreover, he dismissed the argument that the mortgagee should not be the mortgagor's perpetual bailiff by pointing out that the mortgagee received rents and profits throughout the period. For a comprehensive summary of Welsh mortgages, see 1 J. POWELL, *TREATISE ON THE LAW OF MORTGAGES* 373a-407 (6th ed. 1828).

³² See, e.g., *Howell v. Price*, 22 Eng. Rep. 502, 502 (Ch. 1715) (Welsh mortgage "redeemable even at law to the end of the world"). On the decline in the use of Welsh mortgages, see generally 1 J. POWELL, *supra* note 31, at 373a note (E).

³³ 3 W. HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 129-30 (3d ed. 1923); see LITTLETON, *supra* note 27, §§ 325-384. Though this could be styled as a condition precedent providing that "if the feoffor fail to pay at the date certain the specified sum, the feoffee shall possess in fee," the strict limitation of the law of estates concerning creation of an estate in fee to commence in the future led to the use of a defeasible fee in the form of fee simple with a condition subsequent. See E. COKE, *supra* note 27, at 216a-218b. The question of whether a formal reconveyance of the estate by the creditor to the debtor accompanied by livery of seisin was required upon payment of the full indebtedness by proper tender (however defined) or whether extinguishment of the debt sufficed to defeat the condition and restore the estate to the debtor sparked litigation which for several centuries was at the heart of the distinction between "lien theory" states and "title theory" states. For example, New York very early took the position that extinguishment of the debt effectuated a release of the property pro tanto, while other states required a reconveyance of the estate. Compare *Farmers' Fire Ins. & Loan Co. v. Edwards*, 26 Wend. 541 (N.Y. 1841) (payment extinguishes mortgage without need for deed of reconveyance) with *Parsons v. Wells*, 17 Mass. 419 (1821) (deed of reconveyance required). See also 1 J. POWELL, *supra* note 31, at 143a n.1.

condition and forfeiture of the property by noncomplying debtors.³⁴ Under some circumstances, however, debtors found relief in the chancery courts' equitable power to grant what became known as the "equity of redemption"³⁵—the debtor's right to redeem property from the mortgagee upon payment of principal, interest, and costs. Chancery courts recognized the right of redemption even after passage of the date specified in the mortgage instrument.³⁶

The defeasible fee simple became the standard mortgage instrument during the sixteenth and seventeenth centuries.³⁷ Its acceptance as a replacement for the Welsh mortgage was one step in the evolution of the mortgage from a property concept to a contract concept. Through the use of an instrument creating a defeasible fee simple, the debtor usually retained possession of the property. The mortgage instrument thus became primarily a means of providing security for the debt and, consequently, the terms and conditions of the contract took on utmost importance.

The numerous chancery court opinions during the late seventeenth and early eighteenth centuries dealing with the timing for repayment of mortgage debts generally fall into two categories. The first category of cases encompasses debt obligations that specified a date certain for payment, and in which either the debtor or the

³⁴ With one exception, in all of Littleton's examples of estates upon condition the feoffor (the party conveying the estate) has the right to reenter upon payment of the specified sum to the feoffee (the party receiving the conveyance). The only equivalent of a purchase money mortgage as we know it today appears in § 336, where Littleton describes a feoffment made on a condition that "if the feoffee pay to the feoffor at such a day between them limited, twenty pounds, then the feoffee shall have the land to him and to his heirs." LITTLETON, *supra* note 27, § 336.

³⁵ The overwhelming majority of cases dealing with prepayment and redemption rights of mortgage debtors originated in chancery courts rather than common-law courts. The reason for this phenomenon is not entirely clear, though there are three plausible theories. One theory is that there simply was not a pleading available to a debtor who attempted to pay a debt not yet due and was refused. Chancery jurisdiction existed in large measure to provide remedies when none were specifically available at law. See 11 W. HOLDSWORTH, *supra* note 33, at 593 (1938). A second approach suggests simply that the chancery courts asserted jurisdiction to provide relief of a purely equitable nature in order to avoid the harshness of the common law's strict enforcement of conditions. See T. PLUCKNETT, *supra* note 22, at 608. A third and probably most accurate suggestion derives from chancery's traditional jurisdiction over uses and trusts. To the extent that a mortgage existed as security for debt, the payment of debt to the mortgagee resulted in the mortgagee's holding the property as trustee, and the chancery courts were willing to enforce the trust for the benefit of the mortgagor. See 1 J. POWELL, *supra* note 31, at 143-44a; T. PLUCKNETT, *supra* note 22, at 608.

³⁶ It is not possible to point to a specific date or case in which a chancery court first formulated the equity of redemption. Although cases granting relief from forfeiture are found in the early sixteenth century, the substantive development of this doctrine seems to lie with the decisions of Lord Chancellor Nottingham in the late seventeenth century. For the most comprehensive single study of the history of the equity of redemption, see R. TURNER, *THE EQUITY OF REDEMPTION* (1931).

³⁷ 3 W. HOLDSWORTH, *supra* note 33, at 128-30.

creditor died before the specified date.³⁸ The second category encompasses debt instruments that failed to specify a date certain for payment.³⁹ From this latter group of cases emerged the maxims "where a mortgage is once redeemable it is always redeemable"⁴⁰ and "equity will permit redemption of a mortgage even unto the tenth generation."⁴¹

Few cases during this period discussed the debtor's ability to redeem prior to the date certain specified in the underlying debt instrument.⁴² The reason for the lack of case law on this point seems to be that the debt instruments either contained no date for payment, thus allowing the debtor to redeem at will, or specified a date certain for payment, in which case the litigation usually involved an attempt to redeem after the specified date. Parliament enacted in 1734 a statute⁴³ establishing foreclosure procedures that could terminate a debtor's equity of redemption. This statute, however, dealt only with a mortgagee's action to foreclose or recover the debt, not with a mortgagor's right to redeem prior to the date specified in the mortgage.

Because prenineteenth-century mortgage law did not focus on the debtor's right to prepay his or her indebtedness, the question

³⁸ This category includes cases which construe the payment obligation to be the debtor's personal obligation, that is, it must be paid during the debtor's life. *See, e.g.*, *Manning v. Burges*, 22 Eng. Rep. 678 (Ch. 1663) (mortgagee refusing to receive his money on tender after forfeiture shall lose his interest from tender); *Price v. Perrie*, 22 Eng. Rep. 1195 (Ch. 1702) (obligation with condition specifying payment by mortgagor at any point during his life may be redeemed by mortgagor's heir).

³⁹ *E.g.*, *Anonymous*, 22 Eng. Rep. 1073 (Ch. 1681) (where mortgage is payable by mortgagor or his heirs and mortgagor dies, heirs may redeem). This category also includes situations involving Welsh mortgages or obligations similar to Welsh mortgages. *See supra* notes 28-31 and accompanying text.

⁴⁰ *Anonymous*, 22 Eng. Rep. at 1073.

⁴¹ *Bacon v. Bacon*, 21 Eng. Rep. 146 (Ch. 1639); *see* W. HOLDSWORTH, AN HISTORICAL INTRODUCTION TO THE LAND LAW 257 (1927) (mortgagor retains equity of redemption after legal right to redeem lapses).

⁴² For a discussion of the few cases addressing this point, *see infra* notes 51-53 and accompanying text. The earliest case involving a debtor's attempt to pay the indebtedness prior to the date specified that I was able to find was decided in 1313. *Erdington v. Burnel*, Y.B. Mich. 6 Edw. 2, pl. 68 (1313), *reprinted in* 34 SELDEN SOC'Y 234 (1918). In *Burnel*, the debtor tendered the sum due twelve days early but the payment was refused. Following the debtor's death a few days later, his executors again tendered the sum due on the date specified, and again it was refused. The issue was whether an absolute deed could be modified by a collateral loan document; the court held that reconveyance to the debtor was required.

⁴³ Act for the More Easy Redemption and Foreclosure of Mortgages, 1794, 7 Geo. 2, ch. 20. This statute provided that if, after the filing of an ejectment action or an action on a covenant by the mortgagee, the mortgagor paid to the mortgagee or into court all principal and interest due, together with costs, the payment would be deemed in full satisfaction of the indebtedness and the court would be empowered to compel reconveyance of the estate by the mortgagee.

arises: on what basis could nineteenth-century judges and treatise writers conclude that the debtor lacked such a right?

B. The Evidence Reexamined

The pivotal nineteenth-century cases of *Abbe v. Goodwin*⁴⁴ and *Brown v. Cole*⁴⁵ concluded that when a date certain is specified the debtor has no right to prepay without the creditor's consent. A close examination of seventeenth- and eighteenth-century treatises and cases, however, reveals little support for the courts' conclusions.⁴⁶ The evidence suggests that the rules regarding prepayment were actually quite unsettled and that in numerous situations debtors did have a unilateral right to prepay.

Coke's *Commentary upon Littleton* addresses many of the requirements for proper tender by the debtor. For example, Coke states that tender must be made at the place specified or, alternatively, to the person of the creditor.⁴⁷ However, Coke does not address whether the debtor is entitled to pay early when a date certain for payment is specified. One could argue, perhaps, that decisions embracing the rule of perfect tender in time comport with the statement in Kent's *Commentaries on American Law*⁴⁸ that "tender of the debt was required to be at the time and place prescribed."⁴⁹ Such an argument, however, belies Kent's reliance on the passages in Coke's *Commentary Upon Littleton* which deal with the location and identity of the recipient of the tender, not the possibility of an early tender. Both Coke and Kent were primarily concerned with the debtor's ability to make payment *after* passage of the date certain. To draw from these materials the proposition that a debtor is not entitled to prepay is possible only by reading the passages out of context.

In his important *Treatise on the Law of Mortgage*, Powell observed that "although, generally, the mortgagee cannot compel the mortgagor to redeem before the time agreed upon, *videlicet*, the day appointed for repayment of the money; yet, if a hard bargain be made

⁴⁴ 7 Conn. 377 (1829).

⁴⁵ 14 L.J.-Ch. 167 (1845).

⁴⁶ *Abbe* cites the seventeenth-century case of *Talbot v. Braddill*, 23 Eng. Rep. 402 (Ch. 1683), only as an exception to the rule of perfect tender in time. *Abbe*, 7 Conn. at 383. A more accurate interpretation of *Talbot* is that it stands for the reverse proposition, that is, that the debtor *could* prepay. See *infra* notes 63-66 and accompanying text.

⁴⁷ 2 E. COKE, *supra* note 27, at 210.b. Both this portion of Coke's treatise and an earlier part address the nature of the debtor's tender. Both sections focus on the required place of tender, and in both sections Coke affirmatively states that tender by the debtor upon the person of the creditor is required if the sum is in gross. *Id.* at 202.a, 210.b.

⁴⁸ J. KENT, *supra* note 27.

⁴⁹ 4 *id.* at 140.

against the mortgagor, he will be admitted to redeem before that time."⁵⁰ The authorities Powell cited lead to a trilogy of cases decided by the Chancery Court at the end of the seventeenth century: *Newcomb v. Bonham*,⁵¹ *Howard v. Harris*,⁵² and *Talbot v. Braddill*.⁵³ Upon careful examination, however, these cases do not support Powell's assertion that prepayment may not be made without the creditor's consent.

The issue in *Newcomb* was whether a mortgagor's heirs could redeem the property where the mortgage expressly provided (1) that the mortgagor could redeem at any time during his life, and (2) that the property could never be redeemed if not redeemed during the mortgagor's lifetime. In the first opinion in this case, Chancellor Nottingham held that redemption by the mortgagor's heirs should be permitted.⁵⁴ He noted that in this particular mortgage there was no covenant to repay the sum specified. He may thus have equated the mortgage in question with a Welsh mortgage.⁵⁵ Two years later, shortly after Lord Nottingham's death, Lord North of the Chancery Court reheard the case. At the rehearing Lord North intimated that redemption should *not* be permitted under these circumstances and ordered a full hearing.⁵⁶ At the case's third appearance before the Chancery Court, Lord North reversed Lord Nottingham's ruling and denied redemption, stressing two factors: (1) the evidence suggested that this conveyance was intended as a gift because there was no indebtedness underlying the mortgage, and (2) because there was no covenant to repay, the mortgagee could never foreclose.⁵⁷

⁵⁰ 1 J. POWELL, *supra* note 31, at 337.

⁵¹ 23 Eng. Rep. 266 (Ch. 1681), *reh'g granted*, 23 Eng. Rep. 422 (Ch. 1683), *rev'd*, 23 Eng. Rep. 435 (Ch. 1684).

⁵² 23 Eng. Rep. 406 (Ch. 1683).

⁵³ 23 Eng. Rep. 402 (Ch. 1683), *aff'd on rehearing*, 23 Eng. Rep. 539 (Ch. 1686).

⁵⁴ *Newcomb*, 23 Eng. Rep. at 266.

⁵⁵ See *supra* notes 28-31 and accompanying text. Nottingham's opinion reiterates the general rule: "once a mortgage, and always a mortgage." *Newcomb*, 23 Eng. Rep. at 267.

⁵⁶ *Newcomb*, 23 Eng. Rep. at 422.

For several years prior to Nottingham's death, Francis North served as the Lord Keeper of the Great Seal. Nottingham's legal reasoning has provoked a wide divergence of opinions. Roper North, Lord Keeper North's brother, characterized Nottingham as a formalist who "took pleasure in hearing and deciding; and gave way to all kinds of motions the counsel would offer: supposing that, if he split the hair, and, with his gold scales, determined reasonably on one side of the motion, justice was nicely done. Not imagining what torment the people endured, who were drawn from the law and there [in Chancery] tost in a blanket." 1 R. NORTH, LIVES OF THE NORTHS 422-23 (1826). In contrast, Justice Story described Nottingham as the "father of Equity." 1 J. STORY, *supra* note 1, at 58.

⁵⁷ *Newcomb*, 23 Eng. Rep. at 435. A note printed at the end of this opinion indicates that the House of Lords affirmed on May 1, 1689. *Id.*

The second case of the trilogy, *Howard*, involved an attempt by a mortgagor's heir to redeem a mortgage containing restrictions similar to those in *Newcomb*. In this case, which also came before the Chancery Court three times,⁵⁸ the 1673 mortgage specified that the mortgagor, or the male heirs of his body, could redeem the property in 1686 and that none other than the mortgagor or his male heirs could redeem. The mortgagor died without issue, and his widow filed the petition to redeem the property in 1677. In the first proceeding, Lord Nottingham rejected the argument that the express covenant served to prohibit redemption by the widow.⁵⁹ In dicta Nottingham questioned whether prepayment would be permitted, stating, "[o]f this there was some doubt, because the future day seemed to be only in favor of the mortgagor, and yet it would be hard that the mortgagee should be forced to receive his money before the time without convenient warning."⁶⁰ In the final decision in this case, Lord North permitted the mortgagor's wife to redeem because the mortgage contained an express covenant by the mortgagor to pay the debt, thus giving the mortgagee a right to foreclose at any time upon nonpayment.⁶¹ This is a clear instance of a debtor's being permitted to redeem in advance of the date specified without the creditor's permission.⁶²

The third case, *Talbot*,⁶³ is the only one of the trilogy cited in *Abbe v. Goodwin*.⁶⁴ As security for a loan of £320, the debtor in 1657 conveyed to his creditor various possessory and reversionary interests. The debtor could redeem the security interests in March 1688 by paying £380. At the time of the original conveyance, the possessory interests yielded £15 per year and the reversionary interests yielded between £8 and £17 per year. Three years after the mortgage's execution the first of the reversionary interests became possessory (yielding £17 per year). The creditor thus received £32 per year. The debtor in 1682 petitioned Chancery for an order permitting redemption and an accounting of the profits received by the

⁵⁸ See 23 Eng. Rep. 406 (Ch. 1683); 79 SELDEN SOC'Y 617 (1677/8); 23 Eng. Rep. 288 (Ch. 1681).

⁵⁹ *Howard*, 79 SELDEN SOC'Y at 617.

⁶⁰ *Id.*

⁶¹ *Howard*, 23 Eng. Rep. at 406.

⁶² One should not rely too heavily on *Howard* for this proposition, however. Once the mortgagor died without issue, the condition could not be fulfilled without judicial intervention.

⁶³ 23 Eng. Rep. 402 (Ch. 1683), *aff'd on rehearing*, 23 Eng. Rep. 539 (Ch. 1686).

⁶⁴ *Abbe*, 7 Conn. at 383. In *Abbe*, the Supreme Court of Errors of Connecticut rejected *Talbot* as precedent. The court suggested that the case was not on point because it dealt only with an unusual situation involving an unreasonable bargain. *Id.* Powell suggested that *Talbot* was the exception which proved the rule of perfect tender in time. 1 J. POWELL, *supra* note 31, at 337.

creditor. After declaring that he "thought this an unreasonable bargain,"⁶⁵ Lord North ordered redemption and appointed a date for redemption prior to the original date of 1688.⁶⁶

Although these three cases are cited as the primary authorities for the rule of perfect tender in time,⁶⁷ each case suggests that the debtor *did* have the right to redeem the property in advance of the date specified for payment. Both *Talbot* and *Howard* permitted early redemption. In *Newcomb*, redemption was not permitted, but the factual findings strongly suggest that no loan was ever made.⁶⁸ Neither these nor any other cases decided prior to 1825 expressly prohibited prepayment by the debtor. It is equally true, however, that no case has been found to support the general proposition that prepayment *was* permitted during this period. Thus, the direct evidence is inconclusive as to the status of prepayment during the seventeenth and eighteenth centuries. Nonetheless, the indirect evidence, as reflected in the views of courts and commentators on the nature and function of mortgages, suggests the absence of any firm rule prohibiting prepayment.

The equity cases discussed above recognized that it might be inconvenient for the creditor to accept prepayment on short notice. The resolution of this problem, Lord Nottingham suggested, was to permit prepayment only when the debtor gave the creditor sufficient notice of prepayment.⁶⁹ Subsequent cases confirm that courts ordinarily required six months' notice.⁷⁰

⁶⁵ *Talbot*, 23 Eng. Rep. at 402.

⁶⁶ *Id.* at 402-03.

⁶⁷ Subsequent cases and commentaries most frequently cite *Talbot* as precedent. See, e.g., *Abbe v. Goodwin*, 7 Conn. 377, 383 (1829); *Ellis v. Craig*, 7 Johns. Ch. 7, 11 (N.Y. 1823); R. COOTE, A TREATISE ON THE LAW OF MORTGAGE *19; H. HERMAN, COMMENTARIES ON MORTGAGES AND VENDORS' LIENS 111 (1879); 1 J. POWELL, *supra* note 31, at 337.

⁶⁸ *Newcomb*, 23 Eng. Rep. at 267; see also *Fawcett v. Bowers*, 23 Eng. Rep. 785 (Ch. 1693) (redemption in advance of due date decreed where debtor, in consideration of a loan of 300, agreed to pay 60 per year for seven years where debt secured by demise and redemise).

⁶⁹ See *Howard*, 79 SELDEN SOC'Y at 617 ("[T]here was some doubt [as to whether there could be early redemption], because the future day seemed to be only in favour of the mortgagor, and yet it would be hard that the mortgage should be forced to receive his money . . . without convenient warning.").

⁷⁰ E.g., *Anonymous*, 22 Eng. Rep. 508 (Ch. 1740) (debtor given six months to redeem following decree of foreclosure). Six months' notice was not required, however, once the mortgagee brought a bill of ejection. *Sharpell v. Blake*, 22 Eng. Rep. 506 (Ch. 1737).

"It must, however, be observed, that a mortgagor cannot pay off the mortgage debt at any other than the time stipulated, without giving six previous months' notice, according to the rule of equity hereafter mentioned." R. COOTE, *supra* note 67, at *19. Coote also noted that it had been "lately held, that the mortgagee cannot be compelled to receive payment before the day named in the mortgage deed, though the full amount of principal and interest up to the day be offered him." *Id.* (citing *Brown v. Cole*, 14 L.J.-

A review of late seventeenth-century cases on payment of mortgage debts shows that mortgage transactions at that time primarily concerned the repayment of debt, rather than the conveyance of real property. "[I]n natural justice and equity," Lord Nottingham observed in 1675, "the principal right of the mortgagee is to the money, and his right to the land is only as a security for the money . . ." ⁷¹ This perspective on the nature and function of mortgages led Samuel Carter, in the first English treatise devoted exclusively to mortgage law, to conclude that "as soon as the Mortgager pays the Money the Lands belong to him, and only the Money to the Mortgagee." ⁷² Blackstone, ⁷³ Powell, ⁷⁴ and Kent ⁷⁵ reflect similar orientations toward the concept of a mortgage. In light of this understanding, the rule of perfect tender in time would have ill-served the mortgage's primary purpose—securing payment of the debt.

Even at the turn of the nineteenth century, debtors in the United States successfully argued for prepayment. In *McHard v. Whetcroft*, ⁷⁶ for instance, the Court of Appeals of Maryland reversed two lower court opinions which held that tender before the specified date was ineffectual. ⁷⁷ Both cases arose out of a bond dated September 24, 1778, which specified payment "at or upon" September 1, 1788. ⁷⁸ The debtor pleaded payment on March 7, 1781. ⁷⁹ Both counsel agreed that the civil law provided that the specification of a date certain for payment was intended to benefit the debtor and that

Ch. 167 (1845), discussed *supra* text accompanying note 45). Coote was one of the few authors to recognize that *Brown* altered the traditional rule permitting prepayment with notice.

⁷¹ *Thornborough v. Baker*, 36 Eng. Rep. 1000, 1001 (1675).

⁷² S. CARTER, *LEX VADIORUM, THE LAW OF MORTGAGES* 2 (1706) (emphasis added). For a summary of the treatise tradition in mortgage law, see 3 W. HOLDSWORTH, *supra* note 33, at 380-83 (1938).

⁷³ 3 W. BLACKSTONE, *supra* note 27, at *435. Blackstone's analysis adopts this emphasis and suggests the debtor's ability to prepay a mortgage: "the payment of principal, interest, and costs ought at any time, before judgment executed, to have saved the forfeiture in a court of law, as well as in a court of equity." *Id.*

⁷⁴ 1 J. POWELL, *supra* note 31, at 143a-45. Powell suggests that this was true at law as well as in equity. *Id.*

⁷⁵ 4 J. KENT, *supra* note 27, at *193-94. Kent's view typifies this interpretation of the nature of mortgages: "The debt, generally speaking, is considered to be the principal, and the land only the incident; and discharging or forgiving the debt, with the delivery of the security, any time before foreclosure, extinguishes the mortgage and no reconveyance is necessary to restore the title to the mortgagor." *Id.* at *193.

⁷⁶ Although no opinion of the Court of Appeals is given, the reports of the lower court opinions indicate the ultimate outcome of the dispute. See *McHard v. Whetcroft*, 3 H. & McH. 85, 91 (Md. 1791); *Quynn v. Whetcroft*, 3 H. & McH. 136, 139 (Md. 1793).

⁷⁷ *McHard*, 3 H. & McH. at 85; *Quynn*, 3 H. & McH. at 137.

⁷⁸ *McHard*, 3 H. & McH. at 85; *Quynn*, 3 H. & McH. at 136.

⁷⁹ *McHard*, 3 H. & McH. at 85.

the debtor could pay at any time.⁸⁰ They differed, however, as to whether the common law of England and America followed the civil law position. Counsel for the debtor argued that the common law incorporated the civil law on this point,⁸¹ while counsel for the creditor insisted that the common law did not permit prepayment.⁸² The court of appeals found for the debtor in both cases without written opinion.⁸³

An early New York chancery case, *Ellis v. Craig*,⁸⁴ similarly reflects the changing perception of the nature and function of mortgages and the movement toward the rule of perfect tender in time. In *Ellis*, the debtor signed a bond dated July 1818 to pay \$10,000 on May 1, 1825, with interest payable quarterly. The debtor tendered the full amount of principal, plus accrued interest, on August 25, 1820. The creditor refused the tender and insisted that he did not have to accept the principal until May 1825. The debtor ceased paying interest, and the creditor filed for foreclosure.⁸⁵ Evidently the case troubled the chancellor, who initially felt that the authorities supported the debtor's position.⁸⁶ Upon rehearing, the chancellor concluded that the debtor did not have the right to repay the debt prior to the specified maturity date.⁸⁷ As in *McHard*, the court care-

⁸⁰ *McHard*, 3 H. & McH. at 87, 89-90; *Quynn*, 3 H. & McH. at 137-38; cf. *State ex rel. Elliott v. Ratzburg*, 215 La. 295, 40 So. 2d 395 (1949); 1 J. DOMAT, *THE CIVIL LAW IN ITS NATURAL ORDER* ¶ 2245 (L. Cushing ed. 1850 & photo. reprint 1980); 1 M. POTHIER, *A TREATISE ON THE LAW OF OBLIGATIONS* 216-217 (W. Evans trans. 3d Am. ed. 1853) ("It remains to observe concerning the effect of the term, that being presumed to be inserted in favor of the debtor . . . the debtor may very well defend himself from payment before the expiration of the term, but the creditor cannot refuse receiving if the creditor [sic] is willing to pay . . . at least unless it appears from the circumstances that the term was appointed in favour of the creditor, as well as of the debtor.") (citations omitted).

⁸¹ *McHard*, 3 H. & McH. at 90; *Quynn*, 3 H. & McH. at 137-38.

⁸² *McHard*, 3 H. & McH. at 87. The extent to which seventeenth-century English chancery courts followed the civil law in fashioning their equitable decrees as they pertained to mortgages is unclear, though some commentators consider it to be significant. See, e.g., H. HERMAN, *supra* note 67, at 19 ("There can be but little doubt that the modern mortgage . . . is derived from the Roman civil law . . .").

⁸³ From subsequent litigation involving the same parties it appears that the defendant-debtor had tendered funds in full payment of one debt and, upon refusal by the creditor, tendered the same funds in satisfaction of a second debt and, later, in satisfaction of a third. In response to this maneuvering the court of appeals evidently decided that it had had enough and, in its third decision involving these parties, reversed a lower court award in favor of the debtor. *Quynn v. Whetcroft*, 3 H. & McH. 352, 356 (Md. 1795).

⁸⁴ 7 Johns. Ch. 7 (N.Y. 1823).

⁸⁵ *Id.*

⁸⁶ *Id.* at 8. "When the cause was argued the first time, it appeared to me that the weight of authority was in favor of the pretension of the [debtor], and I thought myself bound to yield to that authority, against the dictates of my own judgment. The rehearing and the second argument were applied for, at my suggestion, to the end that a fuller research might be made, and a more mature consideration given to the case." *Id.*

⁸⁷ *Id.* at 13.

fully evaluated the civil law principle that a debtor could prepay a debt. This time, however, the court held the civil law doctrine inapplicable. The court found that the specification of a date for repayment of principal with interest payable periodically indicated that the parties intended the debt to remain outstanding for the period and that both the creditor and debtor have an equal interest in preserving the period of payment.⁸⁸

There is little evidence to support a rule prohibiting mortgage prepayment until the beginning of the nineteenth century. The evidence suggests first that the question of prepayment rights was rarely litigated, second, that courts frequently permitted prepayment, and third, that the rules of law were in a state of flux during this period. Judges and treatise writers of the nineteenth and twentieth centuries who suggest that the rule of perfect tender in time has always been the rule are mistaken. Establishing this error, however, does not explain why or how courts could, within a space of fifty years, embrace with vigor the rule of perfect tender in time. An understanding of the influences behind this transformation in the law and the method by which courts justified the change offers insight into the development of mortgage law in the past and in the future.

C. The Transformation to Perfect Tender in Time

Evolving economic conditions induced the transformation to the rule of perfect tender in time. In the sixteenth and seventeenth centuries secured real estate transactions generally occurred between parties with long-standing and frequent contact in relatively small, closed communities. Prior to the creation of the Bank of Eng-

⁸⁸ *Id.* The court distinguished situations in which the instrument did not require payment of interest during the period of indebtedness, but instead required all interest to be paid at the outset of the loan or at the conclusion of the loan. In such cases, the court acknowledged that the specification of a maturity date would likely be solely for the benefit of the debtor, and thus waivable by the debtor. *Id.* at 10-11. The chancellor's opinion is replete with sympathetic references to the elderly and infirm and to economic policy arguments:

A prolonged time of payment, when money is loaned upon interest, payable periodically, is not always given for the accommodation of the debtor. The time is intended to meet the will and the wishes of both parties; and in the case of persons who are unable to earn money by their own exertions, or to employ it themselves profitably in business, such as aged and infirm persons, women and infants, and also in the case of literary and charitable institutions, a safe investment of money with a prolonged time of payment of the principal, and short times of payment of interest, is most likely to meet their views, and promote their welfare. The interest of money is liable to fluctuation, and money itself is a marketable commodity, and subject to a greater or less demand, according to the vicissitudes of trade and credit.

Id. at 8-9.

land in 1694, borrowers generally executed mortgages in favor of merchant creditors to secure debts which were viewed as secondary to the obligation to provide goods and services. A mortgage conveyance as part of the purchase price of property was quite rare. By the eighteenth century's end other major banking institutions had begun to emerge, serving to depersonalize lending relationships.⁸⁹ In the rapidly expanding agricultural economy of the early nineteenth-century United States, the purchase of property through the use of purchase money mortgages became quite common.

The first half of the nineteenth century was characterized by instability in banking and finance. The rule of perfect tender in time for mortgage prepayments served as one step towards achieving a modicum of stability. The first three decades of that century witnessed significant fluctuations in wholesale prices, fueled in large part by rapid growth in the number of notes issued by commercial state banks. By 1811 the total amount of such notes in circulation was roughly twice the total specie supply of the country.⁹⁰ Such notes were backed by inadequate security, invariably leading to significant depreciation in their value.⁹¹ Banks began to insist on repayment of debts in hard specie or in the notes of another bank.⁹² A panic in 1818 and 1819, induced partially by the sale of large tracts of public western land, resulted in a collapse in market prices. Nevertheless, by 1829, the date of *Abbe v. Goodwin*, both market prices and the number of land sales had increased tremendously. In that year the federal government generated \$1.5 million from the sale of 1.2 million acres of public land; by 1836 this figure had increased to \$25 million from the sale of 20 million acres.⁹³

Arguments before the court in *McHard v. Whetcroft*⁹⁴ suggested that speculation in land prices prompted the adoption of the rule of

⁸⁹ With a few short-lived exceptions, pre-Revolutionary America had no established commercial banks. By 1820 there were 300 banks and by 1860 there were 1,500. L. DAVIS, J. HUGHES & D. McDUGALL, *AMERICAN ECONOMIC HISTORY* 165 (3d ed. 1969).

⁹⁰ C. WRIGHT, *ECONOMIC HISTORY OF THE UNITED STATES* 276 (1941).

⁹¹ It was not unusual for banks to have notes in circulation whose face value was several hundred times the amount of the issuer's cash reserves. W. SHULTZ & M. CAINE, *FINANCIAL DEVELOPMENT OF THE UNITED STATES* 149 (1937); see *Ellis v. Craig*, 7 Johns. Ch. 7 (N.Y. 1823) (citing interest rate fluctuation as reason for denying right of prepayment).

⁹² In *Tillou v. Britton*, 9 N.J.L. 152 (1827), the debtor executed a note for \$250 to a bank and received bank notes in exchange. The bank subsequently transferred the debtor's note to a third party. Prior to the maturity date set forth in the note, the debtor tendered to the bank the original notes he had received upon execution of his promissory note. The bank refused to accept its own devalued notes, insisting on specie. The bank's assignee brought an action to recover on the note. The court held that the debtor's tender of the bank's own notes prior to the maturity date was ineffective. *Id.* at 171-72.

⁹³ P. STUDENSKI & H. KROOSS, *FINANCIAL HISTORY OF THE UNITED STATES* 99 (1963).

⁹⁴ *McHard v. Whetcroft*, 3 H. & McH. 85 (Md. 1791).

perfect tender in time. Counsel for the creditor argued that the specification of a date for payment was for the benefit of both parties, indicating a conscious decision by both parties to allocate the risk of currency depreciation over the term of the debt:

As I [the creditor] will bind myself not to call on you before that day, you shall not pay me before that period; you shall not tie my hands and be at liberty to speculate on me and pay me at the lowest state of depreciation to which paper money may be reduced; but as you take the chance of a fall, give me the chance of its rising in value.⁹⁵

In the early nineteenth century, the view of mortgages as economic investments entailing the risk of significant monetary functions dominated. In contrast to the earlier period in which mortgages were viewed in terms of property laws governing ownership and possession, mortgages increasingly came to be viewed as commercial investment opportunities, with a corresponding need for contractual stability and predictability. The same argument used in *McHard* was one of the deciding factors in *Ellis v. Craig*,⁹⁶ was at the heart of the creditor's counsel's argument in the landmark case of *Brown v. Cole*,⁹⁷ and was repeated throughout the country during the early decades of the nineteenth century. "[T]he maker of a note," stated one court in 1827, "who had received the whole amount of it, should not be permitted to pay it off with a depreciated currency."⁹⁸

The greatly increased use of negotiable instruments reinforced the contractual nature of the mortgage.⁹⁹ Commercial lenders viewed debt instruments as negotiable by necessity, and the debtor's ability to retire the debt prior to the date specified in the note created significant problems of uncertainty.¹⁰⁰ Prior to the adoption in the late nineteenth century of negotiable instrument laws in the United States, an assignee of a mortgagee who received the note without notice to the mortgagor took the mortgage with numerous

⁹⁵ *Id.* at 86-87.

⁹⁶ 7 Johns. Ch. 7 (N.Y. 1823); see *supra* notes 84-88 and accompanying text.

⁹⁷ 14 L.J.-Ch. 167 (1845). "It would be extremely inconvenient to the defendant to receive back his money previous to the 1st of April, on which day the plaintiff was bound to repay the amount. If such a principle was permitted, it might be the cause of much loss to the defendant, by the funds falling during the time." *Id.*; see also *Moore v. Cord*, 14 Wis. 231, 236 (1861) ("But can it not be said that the creditor may have an interest in keeping his money invested, upon security, rather than to have it in his own hands?").

⁹⁸ *Tillou v. Britton*, 9 N.J.L. 152, 174 (1827).

⁹⁹ See generally M. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860*, at 211-216, 265-66 (1977) (discussing impact of negotiable instruments on contract law and effect of merging of law and equity jurisdiction on mortgage law).

¹⁰⁰ Though the law of negotiable instruments requires that the note specify payment at a date certain, the existence of an acceleration clause does not necessarily impair the note's negotiability. U.C.C. § 3-109 comment 4 (1977).

attendant risks.¹⁰¹ By the end of the nineteenth century, payment of the debt to the original mortgagee before the date specified in the note was not a defense to an action brought by a holder in due course without notice of the payment.¹⁰²

Courts rarely acknowledged the economic motivations for the rule of perfect tender in time. Instead, courts rationalized the change by citing the reciprocal relationship between debtor and creditor: because the creditor could not demand payment at will, the debtor could not prepay at will.¹⁰³ This reasoning twisted the language of earlier chancery court cases holding that the *remedy* ought to be reciprocal¹⁰⁴—the right of the debtor to have his property freed of the mortgage was reciprocal to the right of the creditor to foreclose if the debtor failed to pay. Thus, in *Howard v. Harris*,¹⁰⁵ the creditor argued that early redemption violated the reciprocity requirement because the creditor could not foreclose prior to the date specified. The court allowed prepayment, finding reciprocity not in the timing of the payment, but between the obligation of the debtor to repay and the right of the mortgagee to foreclose upon nonpayment.¹⁰⁶

In contrast, under the nineteenth-century formula for reciprocity, a debt not payable upon demand of the creditor is not redeemable upon demand of the debtor.¹⁰⁷ If, prior to the nineteenth

¹⁰¹ See, e.g., *Hoyle v. Cazabat*, 25 La. Ann. 438 (1873) (holding, despite strong dissent, that prepayment of note extinguished debt where assignee of note took without notice to debtor); see also 3 J. POWELL, *supra* note 31, at 903-911; R. COOTE, *supra* note 67, at *301-05.

¹⁰² E.g., *Watson v. Wyman*, 161 Mass. 96, 36 N.E. 692 (1894).

¹⁰³ In the context of the Welsh mortgage it was argued that reciprocity was lacking and that redemption should not be permitted. The argument was expressly rejected, however, most likely because in a Welsh mortgage the mortgagee remained in possession of the property with a right to receive all rents and profits in lieu of interest. *Curtis v. Holcombe*, 6 L.J.C.P. 156 (1837); *Lawley v. Hooper*, 26 Eng. Rep. 962 (Ch. 1745); *Yates v. Hambly*, 26 Eng. Rep. 618 (1742).

¹⁰⁴ E.g., *Copelston v. Boxwill*, 22 Eng. Rep. 664 (1660); 1 J. POWELL, *supra* note 31, at 335. Under the concept of reciprocal remedies, the debtor's ability to redeem a Welsh mortgage despite creditor's inability to foreclose was viewed as an exception to the requirement of mutuality. See *Talbot v. Braddill*, 23 Eng. Rep. 539 (Ch. 1686) (expressly rejecting argument of creditor's counsel that "where one side cannot foreclose, the other ought not to redeem"). Subsequent treatise writers cite *Talbot* and Welsh mortgages as exceptions to the requirement of reciprocal remedies. See R. COOTE, *supra* note 67, at *19. Coote recognized subtle distinctions in the requirements of mutuality, suggesting that "[t]he mutuality. . . need not run *quator pedibus*; the rule only requires that it shall not be competent to one party alone to consider it a mortgage." *Id.*; see also *Exton v. Greaves*, 23 Eng. Rep. 371 (Ch. 1682) (redemption permitted notwithstanding creditor's failure to compel payment).

¹⁰⁵ 23 Eng. Rep. 406 (Ch. 1683).

¹⁰⁶ *Id.* at 407-08. The civil law's express assumption that the date specified in the debt instrument is for the benefit of the debtor also reflects this perspective. See *supra* notes 76-83 and accompanying text.

¹⁰⁷ See *Hanson v. Fox*, 155 Cal. 106, 107, 99 P. 489, 490 (1909); *People v. O'Brien*,

century, the specification of a date for repayment was viewed solely to benefit the debtor, by the early portion of that century the creditor insisted that such a date was intended to benefit him as well.¹⁰⁸ What was ignored in the transition to this formula was the fact that the creditor by this time possessed two independent remedies for nonpayment: the right to foreclose upon the property and the right to sue the debtor directly on the debt.¹⁰⁹ In addition, the terms of a mortgage usually permitted the mortgagee to accelerate the entire indebtedness upon the mortgagor's default in making an installment payment. Thus, the language of reciprocity took on a radically different meaning in order to rationalize this transformation in the law.

Contrary to traditional wisdom, the common law prior to 1825 did not clearly deny the debtor the right to prepay his mortgage. Radical economic changes during the early nineteenth century exerted pressure on the debtor-creditor relationship and forged a change in the law. The history of mortgage payment in the United States since 1825 reflects the growing dominance of contract law principles over property law principles in the interpretation of mortgage clauses. If the common-sense requirements of stability and predictability in economic investments justified the rule of perfect tender in time, the rigidity of this new rule prompted new demands for equitable relief.

II

THE AMERICAN LAW OF MORTGAGE PREPAYMENT

*Abbe v. Goodwin*¹¹⁰ marked a critical point in the transformation of mortgage prepayment law. In embracing the rule of perfect tender in time, the decision reflects the increasing application of contract law principles to questions of mortgage law. The court stated, "it is surely too bald to insist that the obligor, by his own act, may discharge the contract before it is due."¹¹¹ By the latter part of

111 N.Y. 1, 61, 18 N.E. 692, 709 (1888); *Peryer v. Pennock*, 95 Vt. 313, 315-16, 115 A. 105, 105-06 (1921).

¹⁰⁸ See *supra* notes 84-86 and accompanying text.

¹⁰⁹ A seventeenth-century creditor's cause of action for nonpayment of an installment due was in *assumpsit* as opposed to debt. See 7 W. HOLDSWORTH, *supra* note 33, at 78-79 (1926).

¹¹⁰ 7 Conn. 377 (1829); see *supra* notes 13-16 and accompanying text.

¹¹¹ *Abbe*, 7 Conn. at 384. Notwithstanding *Abbe's* reputation as a leading case on mortgage prepayment, prepayment was actually a minor issue in the litigation. The creditor, Goodwin, sold land to the debtor, Abbe, and received a purchase money mortgage for one hundred percent of the purchase price, securing four promissory notes payable one per year for four years. Evidently, during the second year Goodwin discovered that his deed to Abbe described the property as larger than it should have been. In a separate suit for ejectment filed by Goodwin shortly before Abbe commenced his suit

the nineteenth century most American courts had little difficulty embracing the rule of perfect tender in time. Courts justified the rule by invoking freedom of contract principles. An 1861 statement of the Wisconsin Supreme Court is typical:

[C]an it not be said that the creditor may have an interest in keeping his money invested, upon security, rather than to have it in his own hands? Can it not be said that he may insist on it even arbitrarily or obstinately, and without advantage to himself, so long as the contract provides for? It would seem so¹¹²

Between 1850 and 1930, courts across the country adopted the rule.¹¹³ Today, the rule of perfect tender in time remains in ef-

to compel acceptance of prepayment, Goodwin sought to have the error corrected. In an opinion heavily criticized by the Supreme Court of Errors, the lower court in the prior action ruled against Goodwin. In the principal action, Goodwin once again raised the issue of mistake. Abbe argued that Goodwin was barred by the result in the prior action and that Abbe had the right to prepay the mortgage. The Supreme Court of Errors ruled against Abbe on both issues and in doing so made history on the question of a debtor's right to prepay a debt. *Id.* at 383.

Several early nineteenth-century Massachusetts opinions contain language advocating a similar rule. In *Saunders v. Frost*, 22 Mass. 259 (1827), the prepayment issue appears to have been rendered moot by the debtor's tender upon the date specified prior to the court's opinion. The court nonetheless stated, "The tender can be considered valid only in relation to the interest and the amount of the note which was due, for the mortgagee could not be compelled to receive payment until it became due." *Id.* at 266. On the other hand, *Kingman v. Pierce*, 17 Mass. 247 (1821), did not involve a note secured by a mortgage; it involved litigation over a promissory note. Although the primary issue was whether the note was acquired from a third party authorized by the creditor to accept payment, the court suggested, "The promisee was entitled to interest, until the day agreed upon for payment." *Id.* at 248.

¹¹² *Moore v. Cord*, 14 Wis. 231 (1861). The court did not actually rule on the prepayment question; rather, it found that an attempted foreclosure was premature. The court did note, however, that under the civil law the debtor could freely prepay and that the court in *McHard v. Whetcroft*, 3 H. & McH. 85 (Md. 1791), appeared to adopt this position. *Moore*, 14 Wis. at 236. The court also noted the unusual nature of the claim:

This is a question somewhat novel in its character, and one upon which authorities are not numerous, owing doubtless to the rarity of the occurrence as a matter of fact. It is seldom, at least in modern times, that the debtor offers to pay before his debt is due, including interest up to the time [sic] when it is to become due; still more seldom, such offer being made, that the creditor refuses it.

Id.

¹¹³ See *Bowen v. Julius*, 141 Ind. 310, 40 N.E. 700 (1895) (tender one day early held ineffectual); *Abshire v. Corey*, 113 Ind. 484, 487, 15 N.E. 685, 686 (1888); *DaSilva v. Turner*, 166 Mass. 407, 411, 44 N.E. 532, 533 (1896); *Trahant v. Perry*, 253 Mass. 486, 149 N.E. 149 (1925); *Moore v. Kime*, 43 Neb. 517, 521, 61 N.W. 736, 738 (1895) ("The note, to secure which his mortgage was given, was payable at a day certain. The payee was not under any obligation to accept payment before maturity, and [the debtor] acquired no rights as against [the creditor] by offering to pay before"); *Missouri, K. & T. Ry. v. Union Trust Co.*, 156 N.Y. 592, 599, 51 N.E. 309, 313 (1898) ("The outstanding bondholders have a right to receive their debt only as provided by the contract. That right is as sacred as to receive it at all."); *People v. O'Brien*, 111 N.Y. 1, 61, 18 N.E. 692, 709 (1888) ("The time of payment of a pecuniary obligation is a material provision in such contract, and we know of no authority to require a creditor to accept payment in

fect¹¹⁴ except where it has been recently modified by judicial decision¹¹⁵ or by statute.¹¹⁶

To the extent that courts expressed an underlying rationale for the adoption of the rule of perfect tender in time, they merely repeated the common-sense arguments implicit in earlier prepayment cases. Efficiency and economic expectations became dominant justifications for the rule. The dogma of reciprocity between debtor and creditor was also repeated frequently to justify the rule. Yet a careful examination of such economic and philosophical arguments reveals their inadequacy. The rule has been and continues to be applied in ways entirely inconsistent with its economic justifications.¹¹⁷ Similarly, the reciprocity argument fails to take account of cases in which reciprocity is admittedly lacking.¹¹⁸ Notwithstanding these difficulties, however, economic and philosophical perspectives on mortgage prepayment are as important now as they were at the beginning of the nineteenth century. Clarifying these perspectives permits us to determine the extent to which they justify a rule of perfect tender in time in the future.

A. The Economic Justifications

Explaining the custom of denying prepayment rights, one text-writer stated, "This freedom of the mortgagee from anticipation is of increasing value as the mortgage becomes more and more an investment instrument designed to secure a regular flow of income. Current institutional mortgages customarily exact substantial amounts as conditions of accepting prepayment."¹¹⁹ Elaborating on this assertion, the Supreme Court of Connecticut noted,

advance, any more than to compel such payment by the debtor."); *Pyross v. Fraser*, 82 S.C. 498, 499, 64 S.E. 407, 407 (1909) ("Few adjudications of the question here made as to the right of a debtor to pay his debt before maturity are to be found, for the reason that a creditor rarely refuses to accept a premature tender of his debt when it includes interest to the date of maturity."); *Peryer v. Pennock*, 95 Vt. 313, 319, 115 A. 105, 106 (1921); *see also Smiddy v. Grafton*, 163 Cal. 16, 124 P. 433 (1912) (holder of first mortgage cannot be compelled to accept early payment to clear title); *Shipp v. Anderson*, 173 S.W. 598 (Tex. Civ. App. 1915) (debtor has no right to compel creditor to accept payment before maturity).

¹¹⁴ *See, e.g., Lindsay Realty Co. v. Bellina*, 320 So. 2d 572, 574 (La. Ct. App. 1975) ("purchaser does not have the right of prepay unless that right is specifically given to him"); *Peter Fuller Enters. v. Manchester Sav. Bank*, 102 N.H. 117, 120, 152 A.2d 179, 181 (1959) ("A mortgagor, however, in the absence of a provision so providing has no right to pay in advance of maturity."); *see also In re Agostini*, 42 Del. 347, 33 A.2d 306 (Super. Ct. 1943) ("Before the law day, or the day the mortgage is due, the mortgagor has, in general, no right to make payment of the mortgage . . .").

¹¹⁵ *See infra* note 197 and accompanying text.

¹¹⁶ *See infra* notes 185, 187 & 194-96 and accompanying text.

¹¹⁷ *See infra* notes 120-51 and accompanying text.

¹¹⁸ *See infra* notes 152-87 and accompanying text.

¹¹⁹ 3 R. POWELL, REAL PROPERTY 457 n.4 (1949).

In contrast, a mortgage note designed primarily to give the lender security for the timely repayment of his money at a profitable rate of interest will more likely contain a prepayment clause without a penalty attached. The object of the clause is generally to encourage repayment, whereas in the absence of such a clause, courts tend to construe the mortgage note as intended to secure regular investment income to the mortgage over a definite period of time.¹²⁰

The economic pressures that underlie the rule of perfect tender in time have never been comprehensively analyzed. The cases themselves, however, posit four basic economic justifications where the mortgage instrument does not address the prepayment issue: (1) the creditor's transaction costs resulting from unanticipated re-investment of the principal; (2) the need for predictable returns on investments; (3) the need for the stability provided by regular payments over time; and (4) the desire of the creditor to maximize yield beyond the contractual interest rate.¹²¹

1. *Transaction Costs*

Courts have recognized since the late seventeenth century the inconvenience to the creditor which could be caused by an unanticipated payment of indebtedness as a factor in determining prepayment rights. Lord Nottingham's proposed solution to the problem required that the creditor receive reasonable notice of any advance repayment.¹²² By the mid-eighteenth century, courts expressly acknowledged the transaction costs incurred by creditors in locating new investment opportunities.¹²³ *Brown v. Cole*¹²⁴ relied heavily on the "extreme inconvenience" creditors would suffer if debtors could prepay at will.¹²⁵ A 1977 Florida appeals court agreed that a prepayment penalty reflects in part "the cost to [the creditor] of reloan-

¹²⁰ *Dugan v. Grzybowski*, 165 Conn. 173, 176 n.2, 332 A.2d 97, 99 n.2 (1973).

¹²¹ These four justifications are not exhaustive; they are indicative of the most common justifications. Other motivations arise in varied fact situations. See, e.g., *Abbe v. Goodwin*, 7 Conn. 377 (1829) (attempt by purchaser in seller-financed transaction to prepay mortgage in order to force release of property, thereby precluding argument of erroneous legal description); see also *Peter Fuller Enters. v. Manchester Sav. Bank*, 102 N.H. 117, 152 A.2d 179 (1959) (creditor refused prepayment to prevent sale of encumbered business to purchaser intent on moving business out of state to detriment of regional economy) (discussed in A. AXELROD, C. BERGER & Q. JOHNSTONE, *LAND TRANSFER AND FINANCE: CASES AND MATERIALS* 109 (2d ed. 1978)); cf. Harmon, *Prepayment Penalties: Predicting Controversy over Enforceability Based Upon the Late Due-on-Sale Question*, 1 R.E. FIN. L.J. 326 (1986).

¹²² See *supra* notes 69-70 and accompanying text.

¹²³ This rationale was suggested in *Lawley v. Hooper*, 26 Eng. Rep. 962 (Ch. 1745), and carried forward in *Brown v. Cole*, 14 L.J.-Ch. 167 (1845); see also *Carpenter v. Winn*, 39 Colo. App. 238, 566 P.2d 370 (1977).

¹²⁴ 14 L.J.-Ch. 167 (1845).

¹²⁵ *Id.* at 168.

ing or re-employing the use of said prepaid principal."¹²⁶

2. *The Need for Predictable Returns on Investments*

The creditor's concern with the predictability of the return on its investments is a more frequently cited, and perhaps more economically significant, justification for the rule of perfect tender in time.¹²⁷ In *Ellis v. Craig*¹²⁸ the court predicated refusal to permit prepayment upon the recognition that a loan requiring periodic interest payments reflects a conscious investment decision by the creditor.¹²⁹ The underlying assumption is that in a period of fluctuating interest rates creditors prefer a predictable return on their investments, one which could not be defeated by the debtor's prepayment in the event of a decline in interest rates. When the market interest rate declines, the debtor borrowing at fixed rates has an incentive to refinance the debt, while the creditor has a corresponding incentive to protect its contractual interest rate. Indeed, perhaps the most common justification given for prepayment penalties or charges is to "compensate the lender for the fact that the loan does not run to maturity."¹³⁰ Thus, the need to protect the creditor's predictable rate of return against the likelihood that the debtor will refinance the debt if interest rates fall justifies the rule of perfect tender in time.¹³¹ If the creditor cannot demand payment of

¹²⁶ *Century Fed. Sav. & Loan Ass'n v. Madorsky*, 353 So. 2d 868, 869 (Fla. Dist. Ct. App. 1977), *cert. denied*, 359 So. 2d 1217 (Fla. 1978); *see also* *Chestnut Corp. v. Bankers Bond & Mortgage Co.*, 395 Pa. 153, 155-56, 149 A.2d 48, 50 (1959) ("A prepayment clause is ordinarily inserted to compensate a mortgagee for the cost and expenses attendant in making a new long term mortgage loan.").

¹²⁷ *See* *Saunders v. Frost*, 22 Mass. (5 Pick.) 259, 266 (1827) ("He [the creditor] had a right to keep his money on interest according to the contract."); *Kingman v. Pierce*, 17 Mass. 247, 248 (1821) ("The promisee was entitled to interest, until the day agreed upon for payment."); *accord*, *Moore v. Cord*, 14 Wis. 231 (1861).

¹²⁸ 7 Johns. Ch. 7 (N.Y. 1823).

¹²⁹ The court contrasted notes specifying periodic interest payments with notes which do not require payment of interest during the period of indebtedness. *Id.* at 12; *see supra* note 90. This distinction, however, seems naive because many loans during the early eighteenth century were heavily discounted in value upon issuance. Thus the debtor received less than the face amount of the note. *See, e.g.,* *Savings Bank v. Bates*, 8 Conn. 504 (1831). The amount of the discount was, in effect, a form of prepaid interest.

¹³⁰ *Westminster Investing Corp. v. Equitable Assurance Soc'y*, 443 F.2d 653, 658 (D.C. Cir. 1970).

¹³¹ An example of a case where a debtor's prepayment would adversely affect the creditor's financial investment is *City of Portland v. Atlantic & St. L. R.R.*, 74 Me. 241 (1882). The city of Portland had loaned funds to the railroad, financing the loan by issuing city bonds. Following extension of the loan and refinancing of the bonds by the city, the railroad tendered the full amount of the debt plus accrued interest. In upholding the city's position that this was an ineffectual tender, the court stressed that if it permitted prepayment, "the city must be a loser by the difference between the interest it must pay and the interest it can obtain." *Id.* at 250. Evidently, prevailing interest rates at the time of the attempted tender were lower than the stated rates in the debt instruments and the city's bonds were not "callable" by the city.

the debt when market interest rates rise above the contract rate, the debtor should not be able to prepay when market rates decline below the contract rates.¹³²

However attractive this economic argument may seem as a matter of common sense, its application by courts has resulted in creditors' receiving far more than the effective anticipated yield on their investments. Courts rarely attempt to calculate the economic cost to the creditor of prepayment when market rates fall below the contract rate.¹³³ Instead, some courts permit prepayment only when the debtor tenders not only the outstanding principal and accrued interest, but also the interest which would have accrued as of the specified maturity date.¹³⁴ However, the amount of unaccrued interest that the debtor must pay does not necessarily correlate to the creditor's actual economic loss. In addition, although an 1837 case suggests that tender of interest to the date of maturity is proper,¹³⁵ many courts state that even in these situations the creditor is not obliged to accept prepayment.¹³⁶ As recently as 1955 a court held

¹³² This article discusses the conceptual limits of the reciprocity argument in Part II.B, *infra* notes 152-87 and accompanying text.

¹³³ Presumably such a calculation would not be difficult for any given fixed-rate loan with a specified maturity date or specified date upon which prepayment could be made without penalty or charge. It would roughly equal the present value, as of the date of prepayment, of the income stream over the remaining term of the contract of the amount by which the contract rate of interest exceeded the market rate, as applied to the principal repaid. See *Teachers Ins. & Annuity Ass'n v. Butler*, 626 F. Supp. 1229, 1236 (S.D.N.Y. 1986).

If one wishes to factor in the creditor's original portfolio estimate of prepayment or debt retirement, the calculation becomes significantly more complex. See *infra* notes 220-22 and accompanying text. This opinion, however, is clearly not shared by certain courts. See, e.g., *Lazzareschi Invest. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 309, 99 Cal. Rptr. 417, 421 (1971) ("prepayment case does not fall into a simple calculation at any one point of time of the difference between the interest rate on the repaid loan and that which might be available to the lending institution on a new loan of about the same size made to a new borrower").

¹³⁴ See *Pedersen v. Fisher*, 139 Wash. 28, 32, 245 P. 30, 32 (1926). The court noted, No decision has come to our attention, and we think there is none, holding that an interest bearing contractual debt running for a fixed period with interest covering the whole period, and with no provision in the contract for its payment by the debtor at his election before the end of such period, may be paid by the debtor, except by consent of the creditor, *other than by tender of the principal and interest for the whole time*.

Id. (emphasis added). The argument that the creditor is not entitled to charge interest for such period when the debt is fully paid because it was unearned has proven unsuccessful. See *Wishnoff v. Guardian Sav. & Loan Ass'n*, 34 Ill. App. 3d 107, 110, 339 N.E.2d 494, 496 (1975) ("Earned interest is that to which the parties agree.").

¹³⁵ *Eaton v. Emerson*, 14 Me. 335 (1837) (debtor tendered principal two days early, together with interest through specified due date).

¹³⁶ *Abbe v. Goodwin*, 7 Conn. 377 (1829); *Moore v. Kime*, 43 Neb. 517, 61 N.W. 736 (1895); *Pyross v. Fraser*, 82 S.C. 498, 64 S.E. 407 (1909); *Brown v. Cole*, 14 L.J.-Ch. 167 (1845); see also *Duke v. Pugh*, 218 N.C. 580, 581, 11 S.E.2d 868, 869 (1940) ("To constitute a valid tender the offer must include the full amount the creditor is entitled to

that even though the note expressly provided that the debtor "shall have the right to pay off the balance due on the principal plus any unpaid interest and thereby shall be permitted to retire the [debt] without any penalty payment," the debtor must nonetheless pay all interest which would have accrued as of the original maturity date.¹³⁷

One would think that a creditor whose primary concern was the predictability of the yield on its investment would gladly accept prepayment when prevailing market interest rates rise above the contract interest rate of an existing mortgage. Even in these situations, however, courts have upheld a prepayment charge. In *Westminster Investing Corp. v. Equitable Assurance Society*,¹³⁸ the debtor attempted to prepay a debt of \$5.7 million which had an interest rate of four and one-half percent when prevailing market interest rates were at six percent. The creditor refused to accept prepayment, and the court ultimately sustained a prepayment charge of approximately \$50,000.¹³⁹

3. *The Stability Provided by Regular Payments*

In some situations the creditor is less concerned with protecting the yield on its investments than with securing a series of regular payments over a period of time. Several courts have relied upon the specification of payments in equal monthly installments, with complete amortization of the debt over the full term of the monthly installments in concluding no prepayment was permitted.¹⁴⁰ These

receive, including interest to the date of tender."); *Herrington v. Murphy*, 446 P.2d 595 (Okla. 1968) (creditor may refuse tender of principal plus full year's interest only six months after date of loan). *But cf.* *Shope v. Rodenhaver*, 90 Pa. Super. 353 (1927) (promissory note expressly permitted prepayment upon tender of principal, accrued interest, and interest to maturity); *Pedersen v. Fisher*, 139 Wash. 28, 245 P. 30 (1926) (suggestion in dicta that a debtor could prepay with interest to maturity).

¹³⁷ *Edge v. Bice*, 263 Ala. 273, 274, 82 So. 2d 252, 253 (1955). *But see* *Fortson v. Burns*, 479 S.W.2d 722 (Tex. Ct. App. 1972) (court rejected mortgagee's argument that even though note expressly permitted prepayment at any time without penalty, mortgagor must tender principal and interest through anticipated maturity date).

¹³⁸ 443 F.2d 653 (D.C. Cir. 1970). At the time of prepayment, the loan had been outstanding for 12 years, with the outstanding principal balance reduced from an initial loan amount of \$8 million to \$5.7 million. The note permitted the debtor to prepay commencing in the fourth year with the prepayment charge of three percent, declining one-quarter of a percent each year thereafter. *Id.* at 658.

¹³⁹ *Id.* at 658. The court stated, "It may well have been somewhat of a windfall for Equitable to have received the principal amount before the running of the term of the mortgage, given the higher interest rates then prevailing, but we should not take that into account in interpreting this contract." *Id.*

¹⁴⁰ *See, e.g., Hensel v. Cahill*, 179 Pa. Super. 114, 116 A.2d 99 (1955); *Beth-June, Inc. v. Wil-Avon Merchandise Mart*, 211 Pa. Super. 5, 233 A.2d 620 (1967) (dicta). The emergence early in the twentieth century of promissory notes in which the debt was fully amortized in equal installments of principal and interest may have influenced these conclusions.

situations may involve a creditor who has made the loan in anticipation of receiving payments analogous to an annuity.¹⁴¹ Similarly, prepayment of a mortgage may have disadvantageous tax consequences for a seller who has financed the sale of property through a mortgage.¹⁴² Many of the cases which have embraced most strongly the rule of perfect tender in time involved attempts by purchasers of land under installment sales contracts to compel conveyance of the land prior to the date specified for conveyance.¹⁴³ In these situations, however, technically there is no mortgage involved because the seller does not transfer title until the purchaser completes payment in accordance with the contract. Courts justify forbidding prepayment in these cases on two grounds: (1) the seller under an installment sales contract frequently contemplates using the underlying property as security for other loans pending completion of the installment period; and (2) the seller may lack clear title to the property at the time of execution of the sales contract.¹⁴⁴

4. *The Maximization of Yield*

A creditor's desire to maximize yield beyond the contractual interest rate is protected by courts under the doctrine of freedom of contract. Creditors argue that they are entitled to retain whatever prepayment charges or fees are specified in the note and, absent such specification, to garner whatever charges they choose to impose as conditions for accepting prepayment.¹⁴⁵ From this perspective, the size of the prepayment charge will not necessarily correlate to the economic disadvantage a creditor incurs when a debtor refinances to take advantage of lower interest rates. Rather, the size of the prepayment charge will be determined by what the market will bear. As the Fifth Circuit Court of Appeals recently suggested when

¹⁴¹ Cf. *Lindsay Realty Corp. v. Bellina*, 320 So. 2d 572 (La. Ct. App. 1975) (seller's desire for annuity provided by seller-financed debt repayment was material term of real estate listing).

¹⁴² See, e.g., *Williams v. Fassler*, 110 Cal. App. 3d 7, 13, 167 Cal. Rptr. 545, 549 (1980) ("a 50 percent prepayment penalty is valid if the penalty is reasonably related to the obligee's anticipated risk of incurring increased tax liability"); cf. *Henderson v. Guest*, 197 Okla. 443, 172 P.2d 605 (1946) (amount of prepayment treated as ordinary income by seller-creditor).

¹⁴³ See, e.g., *Hanson v. Fox*, 155 Cal. 106, 99 P. 489 (1909); *Carpenter v. Winn*, 39 Colo. App. 238, 566 P.2d 370 (1977); *Reed v. Rudman*, 5 Ind. 409 (1854); *Barrell v. Britton*, 252 Mass. 504, 148 N.E. 134 (1925); *Peryer v. Pennock*, 95 Vt. 313, 115 A. 105 (1921).

¹⁴⁴ See *Nelson & Whitman, Installment Lands Sales Contracts—The National Scene Revisited*, 1985 B.Y.U. L. REV. 1.

¹⁴⁵ See e.g., *Teachers Ins. & Annuity Ass'n v. Butler*, 626 F. Supp. 1229, 1231 (S.D.N.Y. 1986) (creditor arguing for enforcement of note's "default prepayment premium"); *Grissom v. Dye*, 269 P.2d 367, 370 (Okla. 1953) (creditor arguing for "bonus" in consideration for accelerating payment of note).

recognizing a mortgagee's right to refuse to release its lien, "Having a good investment that did not require acceptance of prepayment, it could use market tactics to exact a profit. Our entrepreneurial economic system does not exact moral scruples in deals between parties of equal bargaining power."¹⁴⁶ Assuming a competitive market for mortgages and low transactions costs, the rule of perfect tender in time is one method of allowing creditors to maximize the yield on their investments.¹⁴⁷

Under the four rationales listed above, courts permit refusal of prepayment by applying the default rule of perfect tender in time: when the mortgage instrument does not address the prepayment issue, the creditor's refusal to accept prepayment is justified in economic terms. In a fifth and more common situation, the mortgage instrument itself permits a limited right of prepayment. In the overwhelming majority of residential mortgages issued during this century, the underlying note expressly permits prepayment of twenty percent of the outstanding principal in any one year without surcharge.¹⁴⁸ In nonresidential mortgages, however, there has been a wide variety of prepayment penalties and surcharges.¹⁴⁹

Debtors argue that the enforcement of prepayment charges creates an effective interest rate far above the rate permitted by state usury laws. These challenges have been uniformly unsuccessful. Courts give two reasons for denying these challenges. First, if repayment of the debt in anticipated installments does not violate the

¹⁴⁶ *Houston N. Hosp. Properties v. Telco Leasing*, 680 F.2d 19, 22-23 (5th Cir. 1982).

¹⁴⁷ By extending this argument, apparently a creditor could insist upon a clause in the promissory note absolutely prohibiting prepayment during the term of indebtedness. Such a provision has been held not to be an unreasonable restraint on alienation. *Hartford Life Ins. Co. v. Randall*, 283 Or. 297, 583 P.2d 1126 (1978); *see also* notes 177-79 and accompanying text.

¹⁴⁸ *See infra* notes 188-92 and accompanying text on the impact of Federal Home Loan Bank Board regulations on residential mortgage prepayment clauses.

¹⁴⁹ Some mortgages phrase the prepayment penalty as a number of additional months of interest; they typically charge 6-12 months' interest. *See, e.g., Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971) (6 months' interest); *Century Fed. Sav. & Loan Ass'n v. Madorsky*, 353 So. 2d 868 (Fla. 1977) (12 months' interest); *Berenato v. Bell Sav. & Loan Ass'n*, 276 Pa. Super. 599, 419 A.2d 620 (1980) (12 months' interest).

Other penalties are phrased in terms of a percentage of the outstanding principle. *See, e.g., Westminster Inv. Corp. v. Equitable Assurance Soc'y*, 443 F.2d 653 (D.C. Cir. 1970) (3% of any amount in excess of \$500,000, declining one quarter percent each loan year thereafter); *LandOhio Corp. v. Northwestern Mut. Life Mortgage & Realty Inv.*, 431 F. Supp. 475 (N.D. Ohio 1976) (3.5% of outstanding balance); *Williams v. Fassler*, 110 Cal. App. 3d 7, 167 Cal. Rptr. 545 (1980) (50% prepayment penalty on any amounts prepaid during first five years of loan); *Mutual Life Ins. Co. v. Hilander*, 403 S.W.2d 260 (Ky. 1966) (3% balance); *Rosenfeld v. Savings Bank*, 17 Misc. 667, 17 N.Y.S.2d 652 (Sup. Ct.), *aff'd sub nom. In re Rosenfeld*, 259 A.D. 1025, 21 N.Y.S.2d 158 (1940) (1% upon 30 days notice of prepayment).

usury limitation, then accelerated repayment with a premium does not constitute usury.¹⁵⁰ Second, the debtor's decision to pay a prepayment charge is a voluntary decision to reduce the term of the debt and amounts to a novation by which the creditor and debtor enter into a new agreement which terminates the prior one.¹⁵¹

Economic motivations for the rule of perfect tender in time provide justifications which appeal to one's common sense when examined in isolated fact situations. These justifications, however, occasionally lead to results that are inconsistent with their stated economic motivations. At best this rule of law responds imperfectly to its determinative forces; at worst, it creates significant inequities for debtors seeking to free their property from an encumbrance.

B. The Philosophical Justification: Reciprocity

Since at least the early nineteenth century, courts have used forms of reciprocity between debtor and creditor as a theoretical justification for the rule of perfect tender in time.¹⁵² "A creditor can no more be compelled to accept payments on a contract before, by the terms thereof, they are due, than can a debtor be compelled to make such payments before they are due."¹⁵³

Cases throughout the rest of the nineteenth century carried forward this formalistic approach.¹⁵⁴ Just as with much of contract law, the precise language of the instruments took on a magical quality.

¹⁵⁰ *Savannah Sav. Bank v. Logan*, 99 Ga. 291, 25 S.E. 692 (1896) (where a debt with both principal and interest due by installments paid according to terms of contract is free from usury, transaction is not rendered usurious by voluntary payment of debt in full before some installments matured although as a result creditor would receive, in aggregate, sum amounting to more than principal plus maximum legal rate of interest); *accord Atlantic Life Ins. Co. v. Wolf*, 54 A.2d 641 (D.C. 1947); *Eldred v. Hart*, 87 Ark. 534, 113 S.W. 213 (1908).

¹⁵¹ *Feldman v. Kings Highway Sav. Bank*, 278 A.D. 589, 589-90, 102 N.Y.S.2d 306, 307, *aff'd*, 303 N.Y. 675, 102 N.E.2d 835 (1951) (payment of additional amount to obtain discharge early was "for the making of a new and separate agreement [I]t was not a payment of interest and therefore could not be the basis of a claim of usury."); *see also French v. Mortgage Guar. Co.*, 16 Cal. 2d 26, 104 P.2d 655 (1940); *Williams v. Fassler*, 110 Cal. App. 3d 7, 167 Cal. Rptr. 545 (1980); *Marley v. Consolidated Mortgage Co.*, 120 R.I. 200, 229 A.2d 608 (1967); *Bearden v. Tarrant Sav. Ass'n*, 643 S.W.2d 247 (Tex. Ct. App. 1982). The Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7 (1982), preempted state usury limitations for residential first mortgage loans. The Federal Home Loan Bank Board has, however, construed the Act narrowly as not preempting state laws on prepayment charges. *See* 12 C.F.R. § 590.4(c) (1986); *see also infra* notes 227-28 and accompanying text.

¹⁵² *E.g.*, *City of Portland v. Atlantic & St. L. R.R.*, 74 Me. 241, 250 (1882) ("A creditor cannot enforce the payment of a debt before its maturity. A debtor cannot compel his creditor to receive his debt before it is due. The rights of the parties are equal and reciprocal.").

¹⁵³ *Peryer v. Pennock*, 95 Vt. 313, 315, 115 A. 105, 105 (1921).

¹⁵⁴ *E.g.*, *Pyross v. Fraser*, 82 S.C. 498, 499, 64 S.E. 407, 407 (1909) (to compel creditor to accept prepayment "would be to change the contract of the parties").

The debtor as well as the creditor may benefit from such an approach. Thus, even though a promissory note requires specific periodic payments, if the note provides that the debt shall be paid "on or before" a date certain, courts have held that this language entitles the debtor to pay the indebtedness prior to the date certain.¹⁵⁵ Courts reach the same result when the instrument specifies payment "in" or "within" a certain period.¹⁵⁶ Monthly payments of "at least" a specified amount¹⁵⁷ and "not less than" a certain amount¹⁵⁸ have similarly been construed by courts to grant a prepayment privilege. However, a clause in the promissory note adding the words "if not sooner paid," does not unequivocally grant a right of prepayment.¹⁵⁹

The extent to which courts have sought a right of prepayment within the seemingly innocuous words of promissory notes illustrates the practical limitations of rigid contract theory analysis.¹⁶⁰

¹⁵⁵ *Tryon v. Carter*, 94 Eng. Rep. 1069 (K.B. 1734); *Brent v. Fenner*, 4 Ark. 160, 161 (1842) ("[W]hen a note is payable on or before a particular day, the obligor, by the terms of the contract, reserves to himself the right to discharge the debt at any time before the day named."); *Los Angeles Inv. Co. v. Wilson*, 181 Cal. 616, 185 P. 853 (1919); *Garner v. Sisson Properties*, 198 Ga. 203, 31 S.E.2d 400 (1944); *State ex rel. Elliot v. Ratzburg*, 215 La. 295, 40 So. 2d 395 (1949); *Fortson v. Burns*, 479 S.W.2d 722 (Tex. Ct. App. 1972); cf. *Bradford v. Thompson*, 470 S.W.2d 633 (Tex. 1971) (words "on or before" permit surplus paid at due date for one installment to be applied against the subsequent installment), *cert. denied*, 405 U.S. 955 (1972); *accord*, *Ballard-Hassett Co. v. City of Des Moines*, 207 Iowa 1351, 224 N.W. 793 (1929) (provision in municipal bond for payment on specified date "or at any time prior thereto" authorizes municipality's redemption of bond prior to date specified); *In re John and Cherry Sts.*, 19 Wend. 659, 13 N.Y. Com. L. Rpts. 741 (1839) (words "at or before" confer right to prepay). *But see* *Herrington v. Murphy*, 446 P.2d 595 (Okla. 1968) (words "on or before" do not permit prepayment on other than installment dates when note specifies payments in installments).

¹⁵⁶ *Buffum v. Buffum*, 11 N.H. 451 (1841) ("within one year"); *Schotte v. Meredith*, 138 Pa. 165, 20 A. 936 (1890) ("within ten years"); *Horstman v. Gerker*, 49 Pa. 282 (1865) (payable in five years). *But see* *Hensel v. Cahill*, 179 Pa. Super. 114, 116 A.2d 99 (1955) (where mortgage specified monthly payments of set amount, term "within fifteen years" did not confer prepayment right).

¹⁵⁷ *E.g.*, *Brenner v. Neu*, 28 Ill. App. 2d 219, 222, 170 N.E.2d 897, 899 (1960) (language of payments in equal monthly installments "of at least \$80.00 each . . . obviously grants a prepayment privilege to the maker or mortgagor").

¹⁵⁸ *E.g.*, *Peters v. Fenner*, 294 Minn. 488, 199 N.W.2d 795 (1972). Notes which permit additional payments in multiples of certain amounts at the dates for regular installment payments have also been construed to permit full prepayment on those dates. *Security State Bank v. Waterloo Lodge No. 102*, 85 Neb. 255, 122 N.W. 992 (1909).

¹⁵⁹ *Compare* *Beth-June, Inc. v. Wil-Avon Merchandise Mart*, 211 Pa. Super. 5, 233 A.2d 620 (1967) (words "if not sooner paid" confer prepayment privilege on debtor) *with* *Bloomfield Sav. Bank v. Stainton*, 60 N.J. Super. 524, 159 A.2d 443 (1960) ("if not sooner paid" applies only to final payment). The effect of *Bloomfield's* holding was subsequently modified by statute. *See infra* note 194 and accompanying text.

¹⁶⁰ Courts utilizing formalistic contract theory have occasionally demonstrated a stunning lack of flexibility. For example, some courts have sustained a refusal of tender when the tender was not precisely the amount due. *See* *Duke v. Pugh*, 218 N.C. 580, 11 S.E.2d 868 (1940) (amount tendered insufficient in the amount of \$1.25); *Rolfe v. Pa-*

Judicial willingness to justify prepayment based on subtle contractual language destroys the reciprocity between debtor and creditor—the debtor has the right to prepay, but the creditor must wait to be paid.¹⁶¹ Thus these mortgages are not reciprocal in terms of early nineteenth-century prepayment doctrine. They continue to be reciprocal, however, in terms of sixteenth- through eighteenth-century doctrine: the debtor has a right to have his property freed of the encumbrance upon payment of the debt, and the creditor has a right to receive his investment.¹⁶²

The nineteenth-century reciprocity rationale encounters additional obstacles when the debt is payable on demand. In this situation, the debtor presumably could pay the debt at will. Yet, in *Noyes v. Wyckoff*, the New York Court of Appeals held that even though the debt was payable on demand, tender of the debt by a subsequent purchaser of the property was ineffective because the creditor did not demand payment and the original debtor did not make the tender.¹⁶³

The philosophical justification of reciprocity is also tested when the debtor's early tender of all or part of the debt does not arise solely from circumstances within the debtor's control. This occurs when (1) mortgaged property is taken through eminent domain, (2) insurance proceeds are applied upon casualty loss, or (3) the creditor exercises a contractual right to accelerate the indebtedness. The reciprocity rationale justifies the result reached only in the third situation, and even there the result has not been uniform.

1. *Taking by Eminent Domain*

When property which is security for a mortgage is taken in an eminent domain proceeding, two substantive questions arise con-

trons Androscoggin Mut. Fire Ins. Co., 106 Me. 345, 76 A. 879 (1909) (amount tendered insufficient in amount of \$.09).

¹⁶¹ This lack of reciprocity is recognized, but not considered dispositive, in *State ex rel. Elliot v. Ratzburg*, 215 La. 295, 40 So. 2d 395 (1949).

¹⁶² The role of equity developed most clearly in situations involving the validity of tender after breach of condition—the context for the equity of redemption. In the period of transformation, courts recognized that if a grace period is allowed after breach of the condition, the same principle should apply before breach of the condition. For example in 1841, the Superior Court of Judicature of New Hampshire noted,

By the law of this state, grace is allowed on promissory notes. Upon a note payable at one year from date, no suit can be commenced until the expiration of the days of grace. But it is supposed that the maker may tender at the expiration of the year, or at any time within the days of grace. If he may, there is no objection, in point of principle, to a note by which the maker any tender the money before the holder can make presentment and demand.

Buffum v. Buffum, 11 N.H. 451, 457 (1841).

¹⁶³ 114 N.Y. 204, 21 N.E. 158 (1889).

cerning the creditor's right to part or all of the compensation award. First, may the creditor demand immediate application of the funds towards the outstanding principal debt? Second, is the creditor entitled to insist upon a prepayment charge if one is specified in the note? In response to the creditor's argument that the eminent domain proceeding impairs the security for the debt, the majority of cases have held that the creditor is entitled to a portion of the condemnation proceeds.¹⁶⁴ It is not as clear, however, whether the creditor or debtor can insist that the funds be applied immediately to reduce the debt notwithstanding the fact that the underlying promissory note provides neither a prepayment right nor a right of the creditor to demand payment at will. In these situations the reciprocity concept suggests that the creditor should not be able to insist upon immediate payment of the condemnation award to reduce the debt. The creditor should instead be permitted to insist only that the debtor provide substitute collateral with the funds and that it continue to make the payments specified in the note as they come due. This has not been the result, however: even where the debt was not due under the terms of the note, courts have permitted the creditor to insist upon, and receive, the full amount of the condemnation award towards immediate reduction of the debt.¹⁶⁵ In these situations the concept of reciprocity has not controlled; courts have permitted the creditor to demand payment even though the debtor

¹⁶⁴ See, e.g., *Shavers v. Duval County*, 73 So. 2d 684 (Fla. 1954); *DeKalb County v. United Family Life Ins. Co.*, 235 Ga. 417, 219 S.E.2d 707 (1975); *Jala Corp. v. Berkeley Sav. & Loan Ass'n*, 104 N.J. Super. 394, 250 A.2d 150 (1969). But see *Harwell v. Georgia Power Co.*, 250 Ga. 435, 298 S.E.2d 498 (1983) (equity requires apportionment of condemnation award between mortgagor and mortgagee inasmuch as costs of challenging condemnation fall upon mortgagor); *Investors Syndicate v. Dade County*, 98 So. 2d 889 (Fla. Dist. Ct. App. 1957) (where part but not all of mortgaged property is taken in condemnation action, mortgagee is entitled only to pro rata portion based upon percentage of property taken).

¹⁶⁵ E.g., *Adams v. Taylor*, 253 N.C. 411, 117 S.E.2d 27 (1960). In *Adams* the mortgagor demanded that the mortgagee use the condemnation award to discharge the monthly payments as they came due. The mortgagee insisted that while the award should be applied towards the indebtedness, the mortgagor should be required to make the same monthly payments originally agreed upon, only for a shorter period of time. Upon the mortgagor's nonpayment of the monthly payments, the mortgagee foreclosed. The trial court held that the funds should have been applied towards the monthly payments as they came due. On appeal, the North Carolina Supreme Court reasoned that because "neither debtor nor creditor had a right to direct the manner in which the payment should be used, it became the duty of the court to direct application so as to accord with 'intrinsic justice or the equity of the case.'" *Id.* at 413, 117 S.E.2d at 29 (quoting *Nantahala Power & Light Co. v. Clay County*, 213 N.C. 698, 709, 197 S.E. 603, 610 (1938)). The court determined that intrinsic justice required that the mortgagor apply the award in partial retirement of the debt and that the original term of the note remain the same: it reduced the monthly payment amount to reflect amortization of the remaining debt over its original term.

could not prepay.¹⁶⁶

Courts disagree as to whether a creditor is entitled to a prepayment charge from condemnation proceeds. Some courts have refused to enforce a prepayment charge because the prepayment was not voluntary.¹⁶⁷ Other courts have suggested in dicta that they would enforce a prepayment charge in a condemnation situation if the underlying promissory note expressly permitted a prepayment charge.¹⁶⁸ In these situations, the reciprocity concept should permit the creditor to collect the prepayment charge if indeed the debtor has the right to prepay, but courts do not always reach this conclusion. Thus the concept of reciprocity has proved to be of little force or value when applied to mortgage prepayment in the event of condemnation. Courts have ignored the concept of reciprocity when it should have been applied—in deciding whether the creditor can demand the funds immediately or obtain the funds only as the regular payments come due—and have misapplied the concept of reciprocity when it should have been irrelevant—in situations where the note contained an express prepayment charge.

2. Insurance Proceeds Upon Casualty Loss

Insurance proceeds from casualty losses raise similar questions: (1) whether the creditor can apply the proceeds to reduce the outstanding debt (again, with an impairment of the security argument), and (2) whether the creditor can insist that the debtor pay a prepayment charge out of the insurance proceeds. As to the first question, there has been a sharp division of opinion. In *Thorpe v. Croto*,¹⁶⁹ a mortgage secured six \$200 promissory notes payable in six successive years, with interest payable annually. Prior to the due date on the first note a fire destroyed improvements covered by the mortgage. The insurance company paid the \$247.50 proceeds to the mortgagee, who applied them to satisfy the principal debt of the first note. Prior to the due dates of any of the notes, the creditor filed for foreclosure for nonpayment of interest. The debtor argued that the creditor could not rightfully apply the proceeds to a debt not yet

¹⁶⁶ *E.g.*, *In re John and Cherry Sts.*, 19 Wend. 659, 13 N.Y. Com. L. Rpts. 741 (1839).

¹⁶⁷ *Associated Schools, Inc. v. Dade County*, 209 So. 2d 489 (Fla. Dist. Ct. App. 1968); *DeKalb County v. United Family Life Ins. Co.*, 235 Ga. 417, 219 S.E.2d 707 (1975). In some jurisdictions statutes expressly prohibit prepayment charges in the context of eminent domain. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 183, § 57 (West 1977) (prepayment charge unenforceable when prepayment results from taking of property for any public purpose).

¹⁶⁸ *LandOhio Corp. v. Northwestern Mut. Life Ins. & Realty Inv.*, 431 F. Supp. 475 (N.D. Ohio 1976); *Jala Corp. v. Berkeley Sav. & Loan Ass'n*, 104 N.J. Super. 394, 250 A.2d 150 (1969).

¹⁶⁹ 79 Vt. 390, 65 A. 562 (1907).

due without the debtor's consent. The court agreed with the debtor, holding that the creditor "had no right to apply the money as he did, but that he should have held it until a part of the mortgage debt fell due, and then should have applied it to the part which had fallen due, and as it fell due."¹⁷⁰ In effect, this ruling turned the insurance proceeds into a fund from which the creditor could draw to meet debt and interest payments as they came due. The lengthy and well-reasoned dissent did not argue that the creditor could have applied the funds on receipt to the debt; it argued that the insurance proceeds constituted "security in place of the property burned"¹⁷¹ and that the creditor was neither obligated to draw upon the funds to meet required payments nor permitted to apply the funds to the principal debt. Instead, the dissent suggested, the funds constituted replacement security which the creditor could reach only upon default by the debtor.

Under the nineteenth-century concept of reciprocity, the presence of the insurance proceeds should not have altered the relationship between the parties. The *Thorpe* dissent's reasoning is consistent with this theory. Though there is dictum in other cases which supports the *Thorpe* dissent,¹⁷² courts that have dealt with this question either permit the creditor to apply the insurance proceeds immediately to reduce the debt or require that the creditor apply the proceeds as the debt becomes due.¹⁷³

¹⁷⁰ *Id.* at 393-94, 65 A. at 562.

¹⁷¹ *Id.* at 406-07, 65 A. at 567 (Miles, J., dissenting).

Holding money received on an insurance policy in place of the mortgaged property destroyed, is the exercise of a right by the mortgagee derived from the terms of the mortgage, and his right to that money in no way differs from the right which he had in the property which that money represents, except that, being changed to personal property, possession, in some cases, is necessary in order to protect his right as against third parties; but when a breach of the condition of the mortgage happens, in law, he becomes the absolute owner of the undestroyed part of the mortgaged property and also of the money which represents the part destroyed. He becomes such owner not because the money and property are received as a payment, but because by the terms of the mortgage contract he is to become such on failure of the mortgagor to pay the mortgage debt when due.

Id. The dissent recognized that creditor and debtor could by agreement apply the funds in any way they desired.

¹⁷² See, e.g., *Gordon v. Ware Sav. Bank*, 115 Mass. 588, 591 (1874) ("To the mortgagee [the insurance] was for protection of the security, not for payment of the debt. It was collateral to the debt. Money received from the insurance took the place of the property destroyed, and was still collateral until applied in payment by mutual consent, or by some exercise by the mortgagee of the right to demand payment of the debt, and upon default, to convert the securities."); accord *Pedersen v. Fisher*, 139 Wash. 28, 33, 245 P. 30, 32 (1926) ("insurance is only security for the payment of the mortgage indebtedness and interest at the times agreed upon, and is not a fund from which the creditor is required to take full payment" of debt before it is due).

¹⁷³ A court will enforce a provision expressly granting the mortgagee the right to

Whether a creditor can extract a prepayment charge from insurance proceeds has depended primarily upon the terms of the underlying note. In one case, the promissory note specified a prepayment privilege upon payment of a two percent surcharge.¹⁷⁴ After fire destroyed the mortgaged premises, the Pennsylvania Supreme Court denied the creditor's claim for the prepayment charge. The court recognized that the prepayment charge may have been intended to compensate the creditor for the transaction costs of making a new loan, but compared this to the debtor's loss of its improvements and resulting economic losses. With little analysis, the court concluded, "In such a situation both parties suffer, but the owner suffers most."¹⁷⁵ Significantly, the court suggested that it would enforce a clause expressly providing for a prepayment charge even upon prepayment of the debt through insurance proceeds.

3. *Acceleration of Indebtedness*

The reciprocity concept is pushed to its logical extreme when the creditor has by virtue of its rights under the security documents accelerated the entire debt. In this situation is the creditor entitled to demand a prepayment charge? The reciprocity rationale suggests that because the lender voluntarily exercises its contractual option to accelerate instead of simply insisting upon each payment as it comes due, the lender should not be entitled to a prepayment charge.¹⁷⁶ The cases, however, have split on this point, with little consensus as to reasoning or result. Some courts have concluded that the creditor cannot insist upon a prepayment charge when the creditor has elected to accelerate, because the prepayment is not voluntary on the part of the debtor.¹⁷⁷ Other courts have permitted

apply insurance proceeds toward the outstanding debt notwithstanding the mortgagor's arguments that the insurance proceeds should apply to restoration or rebuilding, or that the mortgagor would incur significantly higher costs in obtaining a new mortgage at higher interest rates. *Giberson v. First Fed. Sav. & Loan Ass'n*, 329 N.W.2d 9 (Iowa 1983).

¹⁷⁴ *Chestnut Corp. v. Bankers Bond & Mortgage Co.*, 395 Pa. 153, 149 A.2d 48 (1959).

¹⁷⁵ *Id.* at 156, 149 A.2d at 50.

¹⁷⁶ In *Peter Fuller Enters. v. Manchester Sav. Bank*, 102 N.H. 117, 152 A.2d 179 (1959), the debtor intentionally defaulted on monthly payments and insisted that the default automatically accelerated the indebtedness. The Supreme Court of New Hampshire held that the default clause was not self-operative, and that the creditor could either accelerate the indebtedness or insist upon payments as they became due. *Id.* at 121, 152 A.2d at 181.

¹⁷⁷ See *In re LHD Realty Corp.*, 726 F.2d 327, 331 (7th Cir. 1984) (mortgagee forfeits right to prepayment premium by exercising option to accelerate debt); *Doering v. Schneider*, 74 Ind. App. 294, 128 N.E. 936 (1920) (if mortgagee has taken steps to declare default, or foreclose upon security, then mortgagee has waived right to insist upon payments in accordance with note); *Kilpatrick v. Germania Life Ins. Co.*, 183 N.Y. 163, 75 N.E. 1124 (1905) (action by creditor commencing foreclosure rendered debt due,

a surcharge when the creditor accelerates the debt,¹⁷⁸ or when the creditor has threatened default and acceleration and the debtor subsequently tenders payment of the outstanding indebtedness and accrued interest.¹⁷⁹

In 1985 the Federal Home Loan Bank Board (FHLBB) issued regulations which expressly prohibit a creditor from insisting upon a prepayment charge when the creditor has invoked or threatened to invoke its rights under a due-on-sale clause to accelerate repayment of the debt.¹⁸⁰ In 1983, the FHLBB had removed all substan-

thus payment of debt was not voluntary and creditor was not entitled to prepayment "bonus"); *Nutman v. Aetna Business Credit*, 115 Misc. 2d 168, 453 N.Y.S.2d 586 (Sup. Ct. 1982) (after electing to accelerate mortgage due to default, mortgagee may not exact prepayment penalty); *Grissom v. Dye*, 269 P.2d 367 (Okla. 1953) (when mortgagee declares default and accelerates full indebtedness, demand is for actual principal and interest then due, thus mortgagee has no right to insist on prepayment charge); *see also infra* note 187 and accompanying text. *But cf.* *Baltimore Life Ins. v. Harn*, 15 Ariz. App. 78, 81, 486 P.2d 190, 193 (1971) (court, in dicta, expressly reserved question).

¹⁷⁸ *See Savannah Sav. Bank v. Logan*, 99 Ga. 291, 25 S.E. 692 (1896) (finding voluntary payment by debtor, even as to unearned interest where mortgagee declared default, threatened foreclosure, and insisted on full payment of debt); *Pedersen v. Fisher*, 139 Wash. 28, 245 P. 30 (1926) (mortgagee entitled to full amount of principal and interest due on date of decree where mortgagor defaulted on interest payment and mortgagee accelerated and foreclosed).

A promissory note which contains a "lock-in" feature prohibiting prepayments entirely during part or all of the loan period may create a perverse incentive for the debtor to default intentionally on its obligations and thereby force the creditor to declare a default and accelerate the entire indebtedness. Such acceleration, however, is usually specified in the note to be at the creditor's option. *See Peter Fuller Enters. v. Manchester Sav. Bank*, 102 N.H. 117, 152 A.2d 179 (1959). Some promissory notes expressly provide for a "default prepayment premium" to cover such an event. *See Teachers Ins. & Annuity Ass'n v. Butler*, 626 F. Supp. 1229 (S.D.N.Y. 1986).

The combination of a due-on-sale clause or lock-in clause together with a clause which provides for a prepayment charge even when the creditor accelerates the debt may strengthen the debtor's argument that the clauses constitute an unenforceable restraint on alienation. *See Sonny Arnold, Inc. v. Sentry Sav. Ass'n*, 633 S.W.2d 811, 818 (Tex. 1982) (Spears, J., concurring). *But see Casey v. Business Men's Assurance Co.*, 706 F.2d 559 (5th Cir. 1983) (10 year lock-in provision together with due-on-sale clause does not constitute unreasonable restraint on alienation). For a discussion of prepayment penalties in the context of due-on-sale clauses *see infra* note 187 and accompanying text.

¹⁷⁹ *See West Portland Dev. Co. v. Ward Cook, Inc.*, 246 Or. 67, 424 P.2d 212 (1967) (upholding 3% prepayment surcharge where mortgagee declared default and full acceleration on May 9th, parties executed rescission of notice of default on May 27th; and 10 days later debtor sought to prepay entire balance because no evidence that debtor relied upon acceleration prior to waiver thereof); *Cook v. Washington Mut. Sav. Bank*, 143 Wash. 145, 254 P. 834 (1927) (actions threatening foreclosure not held waivers of prepayment charge on grounds that foreclosure was at mortgagor's option where mortgagee threatened foreclosure, parties negotiated out by pledge of rentals, and thereafter mortgagor sought to prepay, but bank insisted on prepayment penalty expressly provided in note); *see also Mutual Life Ins. v. Hilander*, 403 S.W.2d 260 (Ky. 1966) (upholding creditor's demand for 3% prepayment penalty); *Berenato v. Bell Sav. & Loan Ass'n*, 276 Pa. Super. 599, 419 A.2d 620 (1980) (prepayment by liquidator held enforceable where sale was due to failure of mortgagor's business).

¹⁸⁰ 12 C.F.R. § 591.5(b)(2) (1986), 50 Fed. Reg. 46,749 (1985); *see infra* notes 188-

tive limitations on prepayment charges in residential mortgages.¹⁸¹ The initial regulations proposed in 1983 carried forward a previous prohibition on prepayment changes when the lender exercises a due-on-sale clause; in the final regulations, however, the FHLBB removed even this prohibition.¹⁸² Nonetheless, within sixty days the FHLBB did an abrupt about-face and reinstated its prohibition on prepayment fees when the lender has invoked a due-on-sale clause.¹⁸³ One year later the FHLBB found it necessary to propose a new regulation strengthening this prohibition when it discovered lenders were refusing to permit mortgage assumptions by purchasers and threatening invocation of due-on-sale clauses, then charging prepayment fees upon prepayment on the grounds that the due-on-sale clause had not actually been invoked.¹⁸⁴ Following an unusually long period for public comment on the proposed regulations, the FHLBB issued final regulations in November 1985 which prohibit a lender from charging a prepayment fee where the lender refuses to permit a purchaser of the property to assume the mortgage.¹⁸⁵ In an extensive explanatory ruling, the FHLBB concluded that it is inequitable to permit a lender to charge a prepayment fee if the lender, in effect, chooses to "call" the loan:

The implicit premise of the rule [prohibiting prepayment without consent of the lender] is that the benefit of the bargain for the lender is to have a credit worthy borrower obligated on the loan for its stated term to maturity In the Board's opinion, equity demands that no prepayment penalty be permitted if a lender does not wish to allow a loan to remain outstanding by approving its assumption by a qualified obligor.¹⁸⁶

This FHLBB decision followed several recent state court opinions and legislative enactments prohibiting prepayment charges under

94 and accompanying text for a summary of the evolution of the FHLBB's regulation of prepayment charges.

¹⁸¹ 48 Fed. Reg. 2373 (1983).

¹⁸² *Id.* at 21,563 (codified at 12 C.F.R. § 591.5(b)(2) (1986)).

¹⁸³ *Id.* at 32,162 (codified at 12 C.F.R. § 591.5(b)(2) (1986)) ("A lender shall not impose a prepayment penalty or equivalent fee for or in connection with acceleration of the loan by exercise of a due-on-sale clause."). The Board identified three factors which necessitated reversal of its position and reimposition of this limitation: (1) the possibility of confusion and unnecessary litigation resulting from different state laws; (2) questions as to whether the regulations preempt state law as to federal lenders, but not other lenders; and (3) Congress's intent to create homogeneity in the secondary mortgage market. 48 Fed. Reg. 32,161 (1983).

¹⁸⁴ 49 Fed. Reg. 32,081 (1984).

¹⁸⁵ 50 Fed. Reg. 46,749 (1985) (codified at 12 C.F.R. § 591.5(b)(2) (1986)).

¹⁸⁶ 50 Fed. Reg. 46,746 (1985) (citation omitted). Though written prior to the final regulations' publication, a recent article anticipated FHLBB movement in this direction. Comment, *Prepayment Penalties After Garn-St. Germain: A Minor Coup for Consumers*, 3 DET. C. L. REV. 835 (1985) (pointing out that while regulations resolve one question about enforcement of prepayment charges, many more questions remain unresolved).

similar circumstances.¹⁸⁷

Thus, when addressing involuntary tenders involving condemnation awards and insurance proceeds, courts have abandoned reciprocity as a philosophical justification for the rule of perfect tender in time. Only in the context of due-on-sale clauses and only after several states and the Federal Home Loan Bank Board enacted prepayment prohibitions have courts consistently applied the reciprocity rationale.

C. Statutory and Regulatory Intervention

With the advent of the long-term, fixed-rate mortgage during the Depression, regulations promulgated by the Home Loan Bank Board (HLBB), and its successor the Federal Home Loan Bank Board (FHLBB), established standards for residential mortgage prepayment charges.¹⁸⁸ The Home Loan Bank Board reversed the default rule of perfect tender in time and provided that if the note failed to specify a prepayment restriction or charge, the debtor had the right to prepay the debt without penalty.¹⁸⁹ The regulations also imposed a ceiling on prepayment charges.¹⁹⁰ The HLBB initially set the ceiling at a maximum of ninety days' interest on the amount prepaid if the amount exceeded twenty percent of the original principal amount of the loan. The Board subsequently increased the ceiling to six months' interest, but retained the twenty percent limitation.¹⁹¹ With minor changes, these provisions gov-

¹⁸⁷ See, e.g., *Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n*, 98 Ill. App. 3d 646, 648, 424 N.E.2d 939, 941 (1981) (when obligee accelerates, "the exercise . . . renders the payment made . . . after maturity and by definition not prepayment"); *Crockett v. First Fed. Sav. & Loan Ass'n*, 289 N.C. 620, 626-27, 224 S.E.2d 580, 585 (1976) (holding exercise of due-on-sale clause valid but prohibiting charge of prepayment penalty); *American Fed. Sav. & Loan Ass'n v. Mid-America Serv. Corp.*, 329 N.W.2d 124 (S.D. 1983) (mortgagee not entitled to three month interest bonus upon exercising due-on-sale clause); *General Motors Acceptance Corp. v. Uresti*, 553 S.W.2d 660, 663 (Tex. Ct. App. 1977) ("Once the maturity date is accelerated to the present, it is no longer possible to prepay the debt before maturity."); N.Y. REAL PROP. LAW § 254-a (McKinney Supp. 1986) (prohibiting prepayment fee upon exercise of due-on-sale clause) (upheld against retroactivity challenge in *Rogers v. Williamsburgh Sav. Bank*, 79 Misc. 2d 852, 361 N.Y.S.2d 531 (1974)); VA. CODE ANN. § 6.1-330.33 (1983) (no prepayment penalty when lender accelerates under due-on-sale clause).

¹⁸⁸ The HLBB and the FHLBB charters to savings and loans association set forth clearly debtor prepayment rights and obligations. Charter K, 24 C.F.R. § 202.9(14)(b) (1938).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ 16 Fed. Reg. 10,628 (1951) (codified at 24 C.F.R. § 145.6-12). This change resulted from an ambiguity in an amendment the prior year over whether the interest penalty was applied to the entire amount of prepayment, or only to the prepayment in excess of 20% of the original loan amount. See 15 Fed. Reg. 2,309 (1950) (codified at 24 C.F.R. § 145.6-12).

erned residential mortgages from 1938 to 1983.¹⁹² In 1983, the FHLBB eliminated all substantive regulations on prepayment charges in fixed-rate mortgages, leaving only a requirement that the existence and amount of any prepayment charge be fully disclosed in the loan documents.¹⁹³

In the last twenty years, states have begun to enact legislation designed to prohibit prepayment charges and otherwise limit the reach of the historic rule of perfect tender in time. New Jersey, for example, in 1968 displaced the common-law rule by limiting prepayment charges during the first five years of a loan and prohibiting them thereafter.¹⁹⁴ In 1979 New Jersey amended the legislation to prohibit entirely prepayment penalties in residential mortgages.¹⁹⁵ Other states have enacted legislation which substantially follows the early FHLBB rules limiting maximum prepayment charges to three to six months' interest.¹⁹⁶ In 1983 the Pennsylvania Supreme Court reversed the rule of perfect tender in time and established a presumption that where the loan documents are silent as to the right of prepayment, the debtor may prepay the debt at any time.¹⁹⁷

The history of the American law of mortgage prepayment is pri-

¹⁹² In 1966 the FHLBB amended the regulations to limit specifically the restrictions on prepayment charges to mortgages secured by homes or combinations of homes and business property. 31 Fed. Reg. 7,508 (1966) (codified at 12 C.F.R. § 145.6-12). The FHLBB later narrowed the restrictions to borrower-occupied homes. 34 Fed. Reg. 12,025 (1969) (codified at 12 C.F.R. § 546.6-12(b)); 44 Fed. Reg. 39,130 (1979) (codified at 12 C.F.R. § 545.8-5(b)).

¹⁹³ 12 C.F.R. § 545.34(c) (1983). The FHLBB retained the default rule that, absent an express prepayment charge, a debtor may prepay a loan without penalty. 12 C.F.R. § 555.15 (1983).

¹⁹⁴ N.J. STAT. ANN. § 46:10B-1-7 (West Supp. 1986) (codifying 1968 N.J. Laws 54). This statute reversed the common-law rule reflected in *Bloomfield Sav. Bank v. Howard Staunton & Co.*, 60 N.J. Super. 524, 159 A.2d 443 (App. Div. 1960).

¹⁹⁵ N.J. STAT. ANN. § 46:10B-2 (1979). Similarly, Pennsylvania enacted a statute prohibiting prepayment penalties in residential mortgages. 41 PA. CONS. STAT. ANN. § 405 (Purdon Supp. 1985). The Pennsylvania statute, however, was preempted by FHLBB regulations which permitted a prepayment charge, subject to maximum limitations, upon full disclosure. 12 C.F.R. § 555.15 (1976); see *Toolan v. Trevoise Federal Sav. & Loan Ass'n*, 288 Pa. Super. 211, 431 A.2d 1012 (1981), *aff'd mem.*, 501 Pa. 477, 462 A.2d 224 (1983); see also N.M. STAT. ANN. § 56-8-30 (1986 Repl.) (prohibiting prepayment charges in residential mortgages).

¹⁹⁶ See, e.g., MASS. ANN. LAWS ch. 183, § 56 (Michie/Law. Coop. 1977). In contrast, Illinois prohibits prepayment charges if the interest rate of the underlying note exceeds 8%. ILL. ANN. STAT. ch. 17, § 6404(2)(a) (Smith-Hurd 1986). See generally G. NELSON & D. WHITMAN, *supra* note 20, at 430-32.

¹⁹⁷ *Mahoney v. Furches*, 503 Pa. 60, 468 A.2d 458 (1983); see also *Burks v. Verschuur*, 35 Colo. App. 121, 123, 532 P.2d 757, 758 (1974) ("We hold that if a mortgagee is to seek a premium or penalty upon prepayment, he must specifically provide therefore in the mortgage instrument"); FLA. STAT. ANN. § 697.06 (West Supp. 1986) ("Any note which is silent as to the right of the obligor to prepay . . . in advance of the stated maturity date may be prepaid in full by the obligor . . . without penalty."). But see *Carpenter v. Winn*, 39 Colo. App. 238, 566 P.2d 370 (1977) (affirming perfect tender in time requirement in context of installment sales contracts).

marily that of the rule of perfect tender in time. The rule's economic justifications are diverse and frequently inconsistent and, when embodied in a strict rule, create incongruous economic results. Similarly, the rule's philosophical justification is also unpersuasive because reciprocity between debtor and creditor is hardly a necessary element of the debtor-creditor relationship and because courts ignore reciprocity in condemnation and insurance proceeds situations. The absence of persuasive justifications for the rule of perfect tender in time has prompted a wide range of judicial and legislative attempts to modify the rule. The federal government, by contrast, has chosen to refrain from all substantive regulation on this issue (with the narrow exception of prepayment penalties in the context of due-on-sale clauses). Nonetheless, new economic forces in the secondary mortgage market, and the probability of federal preemption of mortgage law, increase the need for clarity in this area.

III

THE FUTURE OF MORTGAGE PREPAYMENT

The law concerning prepayment rights and penalties in residential mortgages is less clear now than at any point since the early nineteenth century. At the same time, the demand for residential mortgages is greater than ever before. This demand will be met in large part by the development and expansion of private sources of capital in the secondary mortgage market. The secondary market, in turn, creates pressure for uniformity and certainty in mortgage transactions.¹⁹⁸ These contemporary forces invite a comprehensive reexamination of the role that prepayment charges play in residential finance. These new developments also provide an opportunity to design rules of law which incorporate the equitable concerns that have developed during the historical evolution of mortgage prepayment law.

A. Emergence of the Secondary Mortgage Market

The private secondary mortgage market, created in 1970, has rapidly become a primary source of funds for residential mortgages. In 1983 a total of \$89 billion was raised through the secondary mortgage market, providing almost half of all funds for new home

¹⁹⁸ On the development of standard mortgage loan documents for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, see Jensen, *Mortgage Standardization: History of Interaction of Economics, Consumerism and Governmental Pressure*, 7 REAL PROP. PROB. & TR. J. 397 (1972).

mortgages that year.¹⁹⁹ In 1986 secondary market volume could reach \$225 billion.²⁰⁰ Some observers have estimated that as of 1985 the total amount of mortgage debt outstanding in this country was approximately \$1.7 trillion; estimates of the additional mortgage demand for the next decade range from \$3 to 4 trillion.²⁰¹

The secondary mortgage market consists of the post-origination purchase and sale of mortgage loan instruments. For most of this century, residential loans were retained in portfolios by loan originators who were generally savings and loan associations. Over the last fifteen years, however, this practice has all but disappeared because of two major economic developments. First, the widespread disintermediation which occurred during periods of high interest rates in the 1970s forced savings and loan associations to locate a market for low yield portfolios. Second, demand for residential financing outstripped the combined ability of savings and loan associations and federal agencies to provide funds. These two factors combined to provide the impetus for a secondary mortgage market to attract private capital to the residential finance industry.²⁰²

Since 1970 public trading of mortgage-backed securities has enabled investors to invest in a percentage ownership of a large pool of residential mortgages. In 1970 the federal government took the lead in the "securitization" of mortgages by issuing, through the Government National Mortgage Association (GNMA), the first publicly traded mortgage-backed security.²⁰³ GNMA instruments permit investors to purchase an undivided interest in a pool of federally insured mortgages. The private sector's first major issuance of

199 H.R. REP. NO. 994, 98th Cong., 2d Sess. 14, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 2827, 2835.

200 276 *The Bond Buyer* 911, col. 3 (May 16, 1986) (statement of David O. Maxwell, chairman, Federal National Mortgage Association).

201 K. LORE, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 1-9, 1-14 (Securities Law Series, 1986-87). Fifty-two percent of all 1985 mortgage originations are held on the secondary market. *Id.* at 2-52. See also *Secondary Mortgage Market: Hearing Before the Subcomm. on Housing and Community Dev. of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. 289 (1984) [hereinafter *Hearing*] (statement of William P. McCauley, First Boston Corp.) (estimating \$1.7 trillion in outstanding mortgage debt as of 1985); *id.* at 262 (statement of Lewis Ranieri, Salomon Brothers Inc.) (estimating demand for additional \$3 trillion to finance housing by 1995).

202 For the most comprehensive summary of the secondary mortgage market's origins and processes, see generally K. LORE, *supra* note 201. "The notion of transforming mortgages to sell to a wider market is probably the most important housing finance concept of the last fifteen years." *Id.* at 1-14; see also Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 Sw. L.J. 991 (1986).

203 For an overview of the GNMA securities market, see Miller, *Regulation of Trading in Ginnie Maes*, 21 DUQ. L. REV. 39 (1982).

mortgage-backed securities was in 1977.²⁰⁴ Trade in privately issued mortgage-backed securities grew from \$27 million in 1976 to \$4.7 billion in 1983,²⁰⁵ but federal agency issues continued to dominate the secondary mortgage market.²⁰⁶ To meet projected housing finance needs, and to encourage a larger role for privately issued mortgage-backed securities, Congress enacted the Secondary Mortgage Market Enhancement Act of 1984.²⁰⁷ This Act amended the Securities Acts of 1933 and 1934 and altered the authority of a number of federal financial entities so as to eliminate restrictions hampering the issuance of mortgage-related securities. Mortgage-backed bonds have also been issued on the secondary market. The bonds represent a debt obligation of the issuer which is collateralized by a pool of mortgages.²⁰⁸ The success of the secondary mortgage market is due in part to the examples set by GNMA, the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corporation (FHLMC) during the 1970s and in part to the Secondary Mortgage Market Enhancement Act.

The secondary market is economically successful because (1) mortgage instruments are relatively standardized throughout the country, (2) the market enables institutional investors to invest directly or indirectly in large mortgage pools instead of purchasing and managing single real estate mortgages, and (3) it allows issuers and investors to hedge against risks associated with individual mortgages by aggregating mortgages from different geographical areas. Despite the overall success of the secondary mortgage market, the question of mortgage prepayment continues to affect adversely the viability of mortgage-backed securities.

Prepayment rights have a significant impact on the secondary mortgage market. Allowing debtors to prepay their indebtedness at will and without a premium or surcharge introduces uncertainty into the underlying mortgage pool, which in turn destabilizes the pass-through returns that the investors receive. Uncertainty about aggregate prepayment rates (whether due to voluntary prepayment or involuntary prepayment caused by a creditor's acceleration, eminent domain, or casualty loss) makes the maturity of such investments

204 See K. LORE, *supra* note 201, at 1-4, 1-10.

205 *Id.* at 1-11.

206 See *Hearing*, *supra* note 201, at 91 (table 4).

207 Pub. L. No. 98-440, 98 Stat. 1689 (1984).

208 Numerous variations exist on mortgage-backed obligations. Examples include pass-through certificates or bonds, in which the residential debtor's principal and interest payments are distributed to the investors; pay-through obligations, which are collateralized debt obligations of the issuer; and collateralized mortgage obligations, which are variations on pay-through obligations issued in classes with different repayment priorities so as to offer investors a limited form of call protection. See generally K. LORE, *supra* note 201, at 3-5 to 3-32; 1985 Secondary Mortgage Mkt. Guide (MB) §§ 7.01-.03.

highly unpredictable. Because of this lack of "call protection," investors in mortgage-backed securities demand a higher yield on their investments.²⁰⁹ This demand, in turn, forces borrowers to pay higher interest rates on residential mortgages. One financial manager in the secondary mortgage market has estimated that call protection through some form of prepayment penalty would reduce the typical interest rate for individual home borrowers by as much as one-half of one percentage point.²¹⁰ Congress recognized the seriousness of the mortgage prepayment problem and, in the Secondary Mortgage Market Enhancement Act of 1984, charged the Department of Housing and Urban Development (HUD) to prepare a study of the impact of mortgage prepayment on the secondary mortgage market and to propose "federally standardized mortgage instruments that would contain prepayment penalties."²¹¹

There are three possible methods for providing investors with a degree of call protection. The first alternative is simply to allow the market to function freely, with issuers of mortgage-backed securities purchasing only those mortgages having prepayment penalties if the economic incentive to the ultimate investor is high enough. The second alternative is to attempt to predict in advance prepayment rates on given pools of mortgages and segregate the pools to meet different investor concerns. The third option is to federally preempt prepayment rights and penalties in order to promote standardization and attract investors.

The obvious advantage of the free market approach is the absence of federal regulatory and statutory intervention in the secondary mortgage market. Issuers and investors would determine through competition the most effective pricing mechanism for mortgage-backed securities. Several governmental policies, however, render this approach unfeasible. As noted previously, a number of states have recently restricted the enforceability of prepayment charges in residential mortgages with laws differing markedly from state to state.²¹² The free market approach might be viable if the

²⁰⁹ K. LORE, *supra* note 201, at 1-48 to 1-50. In light of the significant jump in residential refinancings that occurred during the spring of 1986 following a sharp, general decline in interest rates, one expert warned that the lack of call protection in mortgage backed securities will create a "fiasco" in the market. "The market was never designed to handle the refinancing of 50% to 60% of every [mortgage] that's ever been issued. . . . Everyone underestimated the cost of the lack of call protection . . ." 276 *The Bond Buyer* 960, col. 3 (1986) (statement of Lewis Ranieri, Managing Director, Salomon Brothers, Inc.).

²¹⁰ *Interview: Lewis S. Ranieri, Managing Director, Salomon Brothers*, U.S. BANKER, Jan. 1985, 22, 26.

²¹¹ Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, § 212, 98 Stat. 1689, 1697.

²¹² See *supra* notes 194-97 and accompanying text.

federal government were willing to allow residential mortgage funds to flow to those states having the most favorable laws concerning prepayment charges and away from those states restricting such charges. But, as evidenced by its preemption of state laws on due-on-sale clauses,²¹³ Congress is not willing, as a matter of national housing policy, to permit wide regional differences in the availability of housing credit. Indeed, one of Congress's goals in creating the secondary mortgage market was to reduce barriers to the interregional flow of mortgage funds.²¹⁴

The second method for providing call protection to investors in mortgage-backed securities is to predict prepayment rates and create separate classes of securities based on anticipated maturation. The Federal Home Loan Bank Board took this approach and in June 1983 issued a new variation on the mortgage-backed security: the collateralized mortgage obligation (CMO). The CMO starts with the traditional mortgage-backed security structure: the issuer creates a large pool of underlying mortgages to provide collateral for its debt obligations. The CMO's distinctive characteristic is that its securities are divided into classes: fast-pay, medium-pay, and slow-pay. The cash flow from the underlying mortgages is allocated first to the fast-pay class of bonds, second to the medium-pay class, and finally to the slow-pay class. Each class carries a maximum maturity and a predicted maturity based on the projected rate of mortgage prepayment.²¹⁵

Though CMOs have met with a degree of success, their popularity is limited by the difficulty of determining mortgage prepayment rates. Until the turbulent economic period of the late 1970s, mortgage prepayment tables compiled by the Federal Housing Administration were deemed accurate predictors of future rates; the standard assumption was that the average life of a thirty-year fixed-rate mortgage was twelve years.²¹⁶ The FHA tables have proven to be inaccurate predictors, however, and the Public Securities Association has recently promulgated a new mathematical model to predict prepayment rates and thereby evaluate the multiple classes of securities in a CMO.²¹⁷ Even so, assumptions inherent in estimations of prepayment rates have a major impact on the ability of in-

²¹³ 12 C.F.R. § 591 (1983).

²¹⁴ H.R. REP. NO. 994, 98th Cong., 2d Sess., reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2827, 2829.

²¹⁵ See K. LORE, *supra* note 201, at 3-18 to 3-21; Maller, *The Collateralized Mortgage Obligation: The Latest Phase in the Evolution of Mortgage-Backed Securities*, 13 REAL EST. L.J. 299 (1985); 1985 Secondary Mortgage Mkt. Guide (MB) § 7.02[2][c].

²¹⁶ See M. WALDMAN, *THE NEXT STEP IN MORTGAGE SECURITY YIELDS: APPLYING THE EXPERIENCE OF THE 1970s*, at 4 (1981).

²¹⁷ K. LORE, *supra* note 201, at 4-138, 4-143, 4-144.

vestors to predict accurately CMO yields.²¹⁸

The yields on mortgage-backed securities, in the absence of some form of call protection, are subject to two variables: general market interest rates and prepayment rates. These two variables are related in that prepayment rates increase as market rates decrease. Recent studies indicate that the greatest degree of uncertainty in prepayment rates occurs not, as one might expect, when large differences between contract rates and market rates exist, but when the interest rate of the securities is at or near the market rate of interest on new mortgages.²¹⁹ Regional differences in prepayment rates add to the uncertainty.²²⁰ Further, there is little consensus on the extent to which prepayment penalties will provide either the necessary certainty about prepayment rates or the call protection sought by investors.²²¹ The lack of uniformity among state laws and mortgage instruments continues to affect adversely prediction models for mortgage prepayment rates. The market prices of CMO issues necessarily reflect these uncertainties.²²²

The third method for providing call protection for investors in mortgage-backed securities is federal intervention. Such intervention could take the form of either a preemption of state laws on mortgage prepayment which allows the market to set an efficient prepayment charge or a substantive specification of a prepayment

²¹⁸ Lore suggests that "[t]he thorniest issue, and the most critical, is the rate of prepayment, i.e., the prepayment assumptions used to project loan maturity. The range of variables obviously remains a barrier to the marketability of the CMO; its 'peculiarities' remain confusing to investors accustomed to corporate bonds." *Id.* at 2-42; see also Murray & Hadaway, *Mortgage-Backed Securities: An Investigation of Legal and Financial Issues*, 11 J. CORP. L. 203, 247 (1986).

²¹⁹ R. CLAYTON & S. GOLDSTEIN, PREPAYMENT IMPLICATIONS OF MORTGAGE-BACKED SECURITY PRICES 5 (FHLBB Office of Policy and Economic Research Research Working Paper No. 115, 1984). See generally Curley & Guttentag, *Value and Yield Risk on Outstanding Insured Residential Mortgages*, 32 J. FIN. 403 (1977); Dunn & Singleton, *An Empirical Analysis of the Pricing of Mortgage-Backed Securities*, 38 J. FIN. 613 (1983); Hendershott, Sheng Hu & Villani, *The Economics of Mortgage Terminations: Implications for Mortgage Lenders and Mortgage Terms*, 2 HOUSING FIN. REV. 127 (1983).

²²⁰ M. WALDMAN, H. PELTZ & N. LOWEN, REGIONAL DIFFERENCES IN MORTGAGE PREPAYMENTS: PREPAYMENT RATES BY STATE BY FHLMC AND FNMA POOLS (1984).

²²¹ See Dunn & Spatt, *An Analysis of Mortgage Contracting: Prepayment Penalties and the Due-on-Sale Clause*, 40 J. FIN. 293 (1985); F. NAVRATIL, THE ESTIMATION OF MORTGAGE PREPAYMENT RATES (FHLBB Office of Policy and Economic Research Research Working Paper No. 112, 1984).

²²² Congress attempted to address some of the uncertainties confronting issuers of CMOs by authorizing the creation of real estate mortgage investment conduits ("REMICs") in the Tax Reform Act of 1986, Pub. L. No. 99-514, § 671(a)9.A, 1986 U.S. CODE CONG. & ADMIN. NEWS 1, 225-34 (to be codified at 26 U.S.C. § 860A-G). REMICs may issue multiple class collateralized mortgage obligations designed to stagger the prepayment rate among the various classes. *Id.* Whether REMICs may issue such obligations with adjustable (or "floating") interest rates is unclear, however, and this lack of clarity has retarded their development thus far. 279 The Bond Buyer 204 (Jan. 16, 1987).

charge (as was the case for most of this century). While federal preemption of residential finance law has occurred more frequently in the last five years than at any point in our history, it is still not clear whether preemption will extend to laws dealing with prepayment.

B. Federal Preemption

In the wake of *Fidelity Federal Savings and Loan Association v. De La Cuesta*,²²³ Congress enacted the Garn-St. Germain Depository Institutions Act of 1982.²²⁴ *Fidelity Federal* held that FHLBB regulations permitting savings and loan associations to include due-on-sale clauses in mortgage documents preempted contrary state statutes and judicial decisions.²²⁵ Garn-St. Germain made this preemption explicit and extended it to all loans.²²⁶

Whereas the combination of *Fidelity Federal* and Garn-St. Germain leaves little doubt that Congress can, if it so chooses, preempt all state laws concerning mortgage prepayment, whether the FHLBB presently has such authority to preempt such state laws, or whether it has in fact already done so, is not clear. Initially, the FHLBB took the position that Garn-St. Germain authorized the preemption of state laws concerning due-on-sale clauses only, and not laws pertaining to prepayment charges.²²⁷ Within three months, however, the Board reversed its position, concluding that Garn-St. Germain granted it plenary power to interpret the provisions of the Act and balance "the frequently conflicting interests of lenders and consumers in those areas which Congress did not expressly address in the statute."²²⁸ At least in the context of a lender's invoking a due-on-sale clause, the FHLBB concluded that it had statutory authority to preempt state laws which would have permitted prepayment charges.²²⁹

²²³ 458 U.S. 141 (1982).

²²⁴ Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified in scattered sections of 12 U.S.C.).

²²⁵ *Fidelity Federal*, 458 U.S. at 170.

²²⁶ 12 U.S.C. § 1701 j-3. The FHLBB promulgated regulations specifying the extent of preemption of state due-on-sale laws in 1983. 12 C.F.R. § 591.1-.6 (1986).

²²⁷ 48 Fed. Reg. 21,560 (1983). The FHLBB reached this conclusion in declining, in the first instance, to prohibit the enforcement of prepayment charges in conjunction with a lender's exercise of a due-on-sale clause.

²²⁸ Preemption of State Due-on-Sale Laws; Imposition of Prepayment Penalties, 48 Fed. Reg. 32,161 (1983). The Board's prepayment analysis is imbued with nineteenth- and twentieth-century justifications for prepayment penalties. The Board has recited the rule of perfect tender in time as true "[a]t common law." The Board has also recognized both the lender's transactions costs in making new loans and discouraging refinancing when market rates fall below contract rates as justifications for prepayment charges. Preemption of State Due-on-Sale Laws; Imposition of Prepayment Penalties, 49 Fed. Reg. 32,081 (1984).

²²⁹ Preemption of State Due-on-Sale Laws; Imposition of Prepayment Penalties, 50

Though no court has ruled on the precise question, existing Board prepayment charge regulations governing savings and loan associations arguably preempt applicable state laws pertaining to prepayment charges.²³⁰ With the exceptions of prepayment charges in the context of due-on-sale clauses²³¹ and disclosure requirements for prepayment charges,²³² the Board's regulations specify that the existence of a prepayment charge is left to contractual negotiations between the borrower and lender.²³³ In the opinion of the general counsel of the Board, these provisions permit a federal savings and loan association and a borrower contractually to agree to prepayment charges notwithstanding any restrictions imposed by state law.²³⁴ The argument for preemption is that existing regulations concerning prepayment charges leave such charges to negotiation just as earlier regulations left the inclusion of a due-on-sale clause to the parties. The earlier regulations were found substantively to preempt state law under *Fidelity Federal*.²³⁵

If the federal government has not already preempted all state law on mortgage prepayment, the above analysis suggests that such preemption is likely in the near future. Both the congressional mandate to HUD²³⁶ to propose a standardized mortgage instrument which contains a prepayment penalty and the wide diversity of recent state restrictions on prepayment charges emphasize the need for uniformity in mortgage instruments. The market significance of uniform mortgage instruments was a major reason for federal preemption of due-on-sale clauses;²³⁷ this rationale equally applies to the problems created by inconsistent mortgage prepayment laws.²³⁸

Fed. Reg. 46,745 (1985). The Board relied on Garn-St. Germain's legislative history to support its position. The Board concluded that it had "rulemaking authority to provide additional consumer protections for circumstances where the enforcement of due-on-sale would be inequitable." *Id.*

²³⁰ In *Toolan v. Trevoise Fed. Sav. & Loan Ass'n*, 501 Pa. 477, 462 A.2d 224 (1983), the Pennsylvania Supreme Court held that FHLBB prepayment charge regulations preempted state restrictions. The regulations in question were promulgated prior to 1983, but presumably a similar argument could be made with regard to the current regulations.

²³¹ See 12 C.F.R. § 545.34(a) (1986).

²³² *Id.* § 545.34(c).

²³³ *Id.* § 555.15.

²³⁴ Letter from Norman H. Raiden, General Counsel, to the Federal Home Loan Bank Board (Oct. 9, 1985), reprinted at 50 Fed. Reg. 46,745-6 n.1 (1985).

²³⁵ See *supra* notes 223-25 and accompanying text.

²³⁶ See *supra* note 211 and accompanying text.

²³⁷ "Due on sale restrictions . . . adversely affect secondary mortgage markets, which rely on uniform, homogeneous mortgage documents to efficiently operate and provide mortgage money for lenders and homebuyers." S. REP. No. 536, 97th Cong., 2d Sess. 21, reprinted in 1982 U.S. CODE CONG. & ADMIN. NEWS 3054, 3075.

²³⁸ In testimony before a Senate committee considering the Secondary Mortgage Market Enhancement Act, the vice-chairman of the Federal Reserve Board stated, "We have now reached a point where conventional mortgage documents are standardized

Given the increasing demand for residential mortgage funds and the secondary mortgage market's need for some form of call protection, the critical task becomes identifying the appropriate method of meeting these needs.

Historically, mortgage prepayment issues have never been interpreted solely under conventional contract law analysis. From the very origins of mortgage law through recent state and federal limitations on prepayment charges, equitable considerations inherent in property law have entered the analysis in an attempt to balance the rights of the parties in light of the importance of home ownership to the debtor. Any prepayment solution must meet the economic needs of the housing finance market while continuing to reflect the concerns of equity.

C. The Future of Mortgage Prepayment: A Simple Solution

The complexity of the mortgage prepayment problem is due in part to the awkward treatment of prepayment rights in the past centuries. As suggested earlier, prepayment rights have at times been analyzed primarily under a property law analysis involving equitable considerations that permitted a debtor to prepay. At other times the emphasis has been on a purely contractual interpretation of the rights of the parties. Judicial and legislative restrictions on prepayment penalties expressed or enacted over the course of this century reflect resistance to the complete transformation of mortgage law into a subject of contract law.²³⁹ The present complexity of mortgage prepayment is further compounded by the economic pressures of the secondary mortgage market and the possibility of federal preemption. The solution to the problem of mortgage prepayment in the coming decades lies not in mandating a given result to the question of prepayment charges; it is instead found precisely in those factors which have made the problem so complex.

The most efficient and at the same time most sensible solution is to complete the transformation of mortgages into purely financial investments governed by contract law principles, while simultaneously affirming a residential debtor's right to release his property from indebtedness upon payment of the debt. This could be accomplished by allowing a debtor to obtain the release upon providing the creditor with some form of substitute collateral or other assurance that the debt will be paid in accordance with the terms of the

nationally." *Secondary Mortgage Market Enhancement Act of 1983: Hearings Before the Subcomm. on Housing and Urban Affairs of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 232 (1983) (statement of Preston Martin, Vice-Chairman, Federal Reserve System).

²³⁹ See *supra* notes 180-86 and accompanying text.

promissory note. Such assurance could take the form of either a written guarantee of payment from a highly rated credit institution (in which case the debtor would continue to make the scheduled payments of principal and interest) or the direct assumption of the payment obligation by such institution (in which case the original debtor is no longer involved). The basic premise of this solution reflects mortgage law principles from the fifteenth to early nineteenth centuries: the existence of the debt is the primary feature of these relationships and the real property security is secondary to the debt. In the event that a debtor presents a creditor with adequate substitute security for the debt, the creditor would be required to release the encumbrance on the debtor's property.²⁴⁰

This solution can be accomplished through a rule which specifies that if a creditor refuses prepayment then, upon provision of adequate security,²⁴¹ the debtor would have the right to have the mortgage released from the property. This right would constitute a *status* rather than a contract right. It would be a reaffirmation of the equity of redemption during the pre-default period of a loan, and would not be subject to contractual modification or waiver.²⁴² Any

²⁴⁰ This solution is consistent with the subtle, yet highly significant, shift in the FHLBB's recent analysis. The Board suggested, "The implicit premise of the [proposed regulation] is that the benefit of the bargain for the lender is to have a creditworthy borrower obligated on the loan for its stated term to maturity." 50 Fed. Reg. 46,746 (1985). This "benefit of the bargain" approach is consistent with dicta expressed in *Mahoney v. Furches*, 309 Pa. Super. 129, 454 A.2d 1117, *rev'd*, 503 Pa. 60, 468 A.2d 458 (1983):

[I]t would be neither practical nor equitable and, in fact, would be a violation of public policy as a restraint upon alienation, if we were to preclude the satisfaction of this mortgage once the mortgagor has provided for a method of prepayment that enables the mortgagee to reap all the benefits of the bargain

Id. at 136, 454 A.2d at 1120. The Pennsylvania Supreme Court noted this view with approval. *Mahoney v. Furches*, 503 Pa. 60, 66 n.l., 468 A.2d 458, 461 n.l. (1983).

²⁴¹ Determining what constitutes "adequate security" will not be an easy task under this "simple" solution. This is not an insurmountable obstacle, however, because the market could develop ratings for credit institutions and entities that guarantee or assume debt obligations similar to the ratings that presently exist for security instruments.

²⁴² Commenting on *Fidelity Federal* and other cases involving judicial invalidation of voluntary contractual provisions, Haddock and Hall argue that when a right is made inalienable, as in the solution I propose, market inefficiencies result and parties who might enter into similar relationships in the future are discouraged. Haddock & Hall, *The Impact of Making Rights Inalienable: Merrion v. Jicarilla Apache Tribe, Texaco, Inc. v. Short, Fidelity Federal Savings & Loan Ass'n v. De La Cuesta, and Ridgway v. Ridgway*, 2 SUP. CT. ECON. REV. 1 (1983). To the extent that this argument is based on the retroactive invalidation of contract provisions, I concur. My solution could easily be styled so as to have only prospective effect. To the extent that Haddock and Hall argue that the existence of inalienable contract rights themselves create market inefficiencies, I accept this as a valid criticism of my proposal. I suggest, however, that my proposal creates less inefficiency than any alternative method of meeting both legislative demand for residential debtor protection and the pressure exerted by the secondary mortgage market for uniform instruments and call protection.

substantive restriction on this right would be treated much as any "clog on the equity of redemption" has been regarded since the early eighteenth century.

This solution has numerous advantages and few evident disadvantages. Perhaps its most significant advantage is that this solution neither prohibits nor mandates prepayment charges. Thus, the parties' freedom of negotiation in this area would result in the determination of prepayment charges and conditions within a framework of market needs and competition.²⁴³ The simple fact that the debtor could, upon the creditor's refusal to accept prepayment, transfer his debt obligation to the commercial market would have a significant impact on prepayment charges and eliminate many of the inequitable results which presently arise. Regardless of the amount of the prepayment charge specified in the loan documents, market pressures would effectively limit the amount of the charge actually levied.

For example, if a debtor has a \$100,000 thirty-year fixed-rate mortgage at twelve percent (with monthly payments of principal and interest of approximately \$1,028.62) and prevailing interest rates are at ten percent, prepayment of the indebtedness is to the debtor's advantage and the creditor's corresponding disadvantage. The creditor would either refuse prepayment or insist on a prepayment charge on the ground that prepayment denies him his anticipated yield over time. If the promissory note is silent on prepayment, the rule of perfect tender in time controls and the creditor could, depending on the jurisdiction, insist on a charge of \$3,000, \$10,000, or even \$50,000. To the extent, however, that the creditor insists on a charge in excess of the discounted present value of the difference between a twelve percent rate and a ten percent rate over the remaining life of the loan, the debtor could "purchase" an annuity which would provide the creditor with the expected monthly income stream of \$1,028.62. The debtor would, of course, have to pay a premium to the provider of the annuity beyond the loan's outstanding principal balance. That premium would be no greater than the

²⁴³ A variation on this proposal was presented to the court in *In re N.S. Garrett & Sons*, 772 F.2d 462 (8th Cir. 1985). In *Garrett* a debtor sought to refinance two existing mortgages which contained prepayment penalties. By depositing an amount slightly in excess of the total outstanding balance on the existing mortgages with a title insurance company, the debtor was able to obtain a title policy which did not reflect the existing mortgages as encumbrances. The title company acted as escrow agent in making scheduled payments on the mortgages from the funds deposited into escrow. Though the lawfulness of this procedure was not at issue in the litigation, the court did consider it "a very questionable scheme" based upon "a commitment for title insurance which debtors knew to contain false information." *Id.* at 466.

The proposal set forth in this article would permit similar financial alternatives without presenting the question of accuracy of title commitment disclosures.

discounted present value of the difference between the contract rate of interest and the market rate of interest plus an amount representing the provider's profit. The debtor could obtain the funds to purchase this annuity either from the sale of the property or from the refinancing proceeds.

Conversely, if the contract rate is only eight percent and the prevailing market rate is ten percent, presumably the creditor would be happy to receive prepayment in order to reinvest the funds at the higher rate. If, however, the creditor refuses to accept prepayment, either because the creditor simply prefers the predictable income stream or because the promissory note provides for a significant prepayment charge, the debtor could release his property from the mortgage by purchasing the annuity at a discount reflecting the lower prevailing rates of interest. The debtor would obtain the benefit of this discount only because the creditor refused to accept prepayment.

In each of these situations the creditor could waive or reduce the contractually specified prepayment charge. Indeed, the possibility of the debtor's transferring the debt obligation to a third party would likely be sufficient incentive for the creditor to renegotiate the prepayment charge to a level which more accurately reflects the costs or benefits of prepayment of the debt. This proposal would not impose any limitations on initial negotiations between the debtor and creditor concerning a prepayment charge, nor would the proposal necessitate any particularized inquiry into the motivations or expectations of a given creditor or debtor. To the contrary, my suggestion would maximize the flexibility of the parties' economic goals, subjecting them only to overall market conditions. Creditors would still receive the benefit of a drop in market interest rates when they have loaned money initially at a higher rate; the proposal would simply create a market limitation to the economic value of this benefit. If a creditor for some reason wished to avoid prepayment regardless of changes in interest rates and instead desired the stability of a regular income stream over time, the debtor could meet these needs without adverse effect on the creditor.

This proposed solution has the additional advantage of meeting the needs of the secondary mortgage market with minimum substantive legislative or regulatory intervention. The proposal provides call protection against early prepayment of mortgage debt because creditors would presumably insist on a prepayment charge in the loan documents. The amount of the charge effectively paid (either directly by the debtor to the creditor, or indirectly to a third party) would reflect the market interest rates. Investors in mortgage-backed securities would be assured that this market determina-

tion of the value of the interest rate differential would accompany any prepayment of principal. The present difficulties in developing accurate models for prepayment rates would become moot in light of this change. The secondary mortgage market's need for uniformity in underlying pooled mortgages would not be met through a standard form promulgated by the FHLBB containing mandatory terms and conditions for prepayment charges. Rather, the uniformity would exist because the yield of the mortgages would be common as to any given interest rate in the mortgage pool.²⁴⁴ In addition, this proposal alleviates the difficulties faced by individual residential borrowers forced to make extremely complex projections of future mortgage rates in order to negotiate proper prepayment charges. The calculations would be made by sophisticated credit institutions, which could simply quote to the debtor the cost of having the institution assume the debt.

Federal preemption of inconsistent state laws could effectively implement this solution. Although the Federal Home Loan Bank Board's authority to preempt state laws on this issue is unclear, Congress could elect to preempt such state laws to the extent necessary. The preemption would be in the form of regulations specifying that a creditor of a residential mortgage is required either to accept prepayment or to release the real property from the mortgage upon receiving adequate substitute collateral for the debt in the form of a guarantee or direct assumption of the debt from a credit-worthy institution or entity. The regulations could either define "credit-worthiness" or could leave it to the creditor's reasonable determination.

This proposal would neither adversely affect the existing status of due-on-sale clauses nor impair their function for creditors. Mortgages could still contain due-on-sale clauses effectively preventing a purchaser from assuming (without the creditor's consent) an existing mortgage with a below-market interest rate. To the extent that creditors rely upon due-on-sale clauses to retire mortgages with below-market interest rates, they can continue to do so. Because the proposal requires that a debtor offer prepayment to the creditor before exercising the right to provide substitute collateral, it prevents debtors from circumventing due-on-sale clauses by purchasing substitute collateral at a discount and then selling the property. Creditors could still provide for prepayment penalties in the loan

²⁴⁴ This proposal does not address the predictive difficulties posed by early termination of mortgages due to debtor default. These difficulties could, however, be addressed through private residential mortgage insurance which is currently available. If this problem remains significant for investors in the secondary market, it may be necessary to rely more heavily on mortgage payment guarantees instead of insurance.

documents and thereby benefit in periods of falling interest rates to the extent of the market's determination of the economic value of the interest rate differential.

CONCLUSION

Mortgage prepayment is a concern to residential homeowners across the country. Present laws governing the right of a homeowner to prepay and the right of a creditor to insist upon a prepayment fee or charge vary tremendously from state to state. Recent widespread demand for residential finance, coupled with significant interest rate fluctuations and the emergence of the private secondary mortgage market, have created pressure for uniformity and predictability in mortgage finance. Significant changes in the law of mortgage prepayment are likely to occur within the next few years. The current task is to shape these new developments in a coherent manner that responds to the needs of debtors and creditors alike. A thorough understanding of the historical development of mortgage prepayment law assists in shaping properly the future of mortgage prepayment.

A dominant theme in the history of mortgage prepayment law has been the tension between the application of equitable principles of property law and the rigid application of contract law. From the fourteenth through the eighteenth centuries, equity courts played a major role in protecting a debtor's right to obtain a release of a mortgage upon payment of the debt. No clear rule restricted or prohibited prepayment of a debt without the creditor's consent. Instead, equity courts placed the emphasis on the debt itself; the property merely provided security for payment of the debt. Timing of the debt's payment was of little consequence so long as the debt was paid by the date specified.

The rule of perfect tender in time, which prohibited prepayment without consent of the creditor, first emerged in the early nineteenth century. Adopted throughout the United States, this rule was interpreted and applied with the full rigor of contract formalism. Twentieth-century courts and legislatures have attempted to mitigate the harshness of the rule by placing limitations on prepayment charges and stretching vague language in the loan documents to find a right of prepayment. The recurring tension between property and contract law demonstrates that the residential mortgagor has something more at stake than simply a financial investment.

The gradual shift towards the commercialization of mortgages presents a second theme in the history of mortgage law. Beginning in the early nineteenth century, creditors viewed mortgages primarily as financial investments. Prior to that time mortgages were cer-

tainly investments, but they were investments made in the context of on-going personal relationships between debtors and creditors. For the past one hundred and fifty years, however, mortgages have been freely transferred among creditors as investments. Today the overwhelming majority of mortgages become commercial paper which is securitized on the secondary mortgage market. Debtors, however, have not yet achieved the same degree of commercial flexibility in transferring their debt obligations to third parties.

A third theme which runs throughout mortgage prepayment law is the philosophical reliance on reciprocity to justify the legal rules. These concepts have themselves undergone subtle yet significant transformation over the centuries from emphasizing reciprocity of remedies to emphasizing that if a creditor could not demand payment at will, a debtor could not pay the debt at will. For the past century, however, the concept of reciprocity has rarely been applied consistently.

The historical development of prepayment law provides insights to a solution to the present challenges facing mortgage prepayment. The solution is radical for its simplicity, yet it is grounded in common sense. The solution recognizes the debtor's right to compel release of the mortgage upon provision of adequate substitute collateral if the creditor refuses to accept prepayment. The substitute collateral could take the form of a guarantee or of a direct assumption of the debt by a third party.

Simple solutions are rarely adequate for complex problems, but in this case I think it works. First, by recognizing the debtor's unwaivable status-based right to clear his property of a mortgage upon provision of substitute collateral, the proposal affirms a consideration long recognized in equity—the debtor's interest in the property frequently goes beyond that of simply a financial investment. Second, by treating the debt as a secured transaction, the proposal completes the transformation of mortgage indebtedness from a property concept to a contract concept.

The proposed solution allows the debtor, as well as the creditor, to commercialize the debt: it allows the debtor to place the mortgage on the same purely economic foundations as does the creditor. Thus, in circumstances involving either condemnation awards or casualty insurance proceeds, the debtor could use the funds to purchase the agreement of a third party to pay the debt in the expected manner. The original debtor and creditor may negotiate a prepayment charge in these circumstances, but the debtor could either pay the charge or put the debt obligation on the market so as to release the property from the mortgage and then refinance, if desirable.

This proposed solution is consistent with the philosophical concepts of reciprocity as they have developed over the centuries. The prenineteenth-century formula of reciprocity was that a creditor has a right to take the property if the debt was not paid and the debtor had a right to have the property freed of the mortgage if the debt was paid. The nineteenth- and twentieth-century formula of reciprocity has been that if the creditor cannot demand payment at will, the debtor cannot pay at will. My solution combines and reconciles these formulas: if the creditor cannot demand payment at will, the debtor cannot prepay at will, but the debtor does have the right to have the property freed of the mortgage if a third party guarantees the debt.

The proposal further allows individual debtors and creditors to negotiate freely prepayment charges, but subjects them to limits on the effective costs of mortgage prepayments established by the financial markets. It meets the needs of the residential finance market with minimum interference with the market, and at the same time it recognizes that, to the homeowner, the home is not merely security for a debt.